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EUROSYSTEM

The case for a better functioning securitisation market in the European Union

A Discussion Paper - Responses

October 2014

The case for a better functioning securitisation market in the European Union

Responses

Bank of England staff
Bank of England
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Dear Sir / Madam

The case for a better functioning securitisation market in the European Union

We appreciate the opportunity to respond to this discussion paper. The Association of British Credit Unions Limited (ABCUL) is the main trade association for credit unions in England, Scotland and Wales. Out of the 393 credit unions which choose to be a member of a trade association, 72% choose to be a member of ABCUL.

Credit unions are not-for-profit, financial co-operatives owned and controlled by their members. They provide safe savings and affordable loans. Some credit unions offer more sophisticated products such as current accounts, ISAs and mortgages.

At 31 December 2013, credit unions in Great Britain were providing financial services to 1,122,461 people, including 126,217 junior savers. The sector held more than £1.1 billion in assets with more than £676 million out on loan to members and £949 million in deposits.[1]

Credit unions work to provide inclusive financial services has been valued by successive Governments. Credit unions' participation in the Growth Fund from 2006 – 2011 saw over 400,000 affordable loans made with funding from the Financial Inclusion Fund. The DWP has contracted ABCUL to lead a consortium of credit unions under the Credit Union Expansion Project, which will invest up to £38 million in the sector and aims to make significant steps towards sustainability.

Response to discussion paper

We are principally concerned in responding to this discussion paper to highlight the role that secondary markets and securitisation play in facilitating the extension of credit by credit unions in the USA and, therefore, the potential that a revived and expanded securitisation market could have in Britain. This would be in line with broader efforts to grow credit unions and enhance competition in UK financial services.

In the USA more than 40% of the population use credit unions. This compares with a figure of approximately 2.5% in Britain. There are numerous historical and structural reasons for the position of US credit unions, not least the localised and fragmented banking and financial

[1] Figures from unaudited quarterly returns provided to the Prudential Regulation Authority

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sector which has deep roots in the history of de-regulated US finance. However, a key factor in their continuing success is their ability to provide a full service offering to their members so that a typical member of the public can fulfil their whole range of financial needs with a credit union. There are a range of different services which this encompasses, of particular importance being transactional banking, however credit products – in particular mortgage and auto loan products – are of central importance as the principal source of revenue for credit unions.

While credit unions in the US in aggregate are much larger than their British counterparts and some of the largest institutions are very large – the largest, Navy Federal Credit Union, has 4.5 million members and more than $50 billion in assets – the vast majority of US credit unions are below $100 million in assets. At these leverages, credit union mortgage finance in particular (but also certain forms of other larger-sum, longer-term finance) which is held to maturity on the originator's balance sheet would be precluded due to scale. Thanks to the availability of liquid securitisation markets, however, US credit unions of virtually all scales can originate mortgages for their members and sell them for securitisation.

A critical feature in this process are the institutional arrangements provided under the Government Sponsored Entities (GSEs), Fannie Mae and Freddie Mac. While the US credit union regulator – the National Credit Union Administration – has recently reformed its regulations for credit unions in order to allow larger credit unions a level playing field in issuing their own asset-backed securities, for most credit unions they are not at a sufficient scale or level of sophistication to do so. Instead they rely upon the sale of mortgages and other loan assets to the GSEs for their use in the construction of ABSs for sale into the secondary market.

Of course, we appreciate fully the controversial position which the GSEs have occupied in the US and around the world since the Global Financial Crisis given their facilitation of securitisation. However, we are also aware that underwriting, origination and participation standards have been significantly tightened since 2008 and this has facilitated the GSEs repaying their obligations to the US Government which was required to bail out the GSEs during the crisis.

We are very supportive of the Bank of England and European Central Bank exploring the options for expanding securitisation in Europe with a view to expanding the European credit supply. We feel strongly that the example of full service credit unions in the US demonstrates the capability of this process to open up new sources of credit for the benefit of the economy. We therefore endorse the Bank's identification of the benefits of securitisation. Similarly, we are broadly supportive of the identified impediments to both issuers and investors in securitised assets and the benefits of a qualified securitisation model with better underwriting and information as standard.

What we would like to stress, however, is that it is our opinion that the securitisation market will only be boosted to the levels seen in the US – and for the benefit of those currently denied fair access to credit – if there are supportive institutional arrangements put in place to facilitate the origination and sale of loan assets for securitisation by community institutions like credit unions. Such an institutional arrangement would not need to be government-backed, but without at least private facilitation we do not think the full benefits of securitisation will be realised in Europe.

We are grateful for the opportunity to respond to this consultation. We would be more than happy to discuss any of the points raised above in more detail. Please feel free to contact us.

Yours sincerely,

M Lyonette

Mark Lyonette
Chief Executive – ABCUL

afme/
Finance for Europe

7 July 2014

To: The Bank of England and the European Central Bank
Submitted via email to:
Securitisation2014@bankofengland.co.uk and
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Re: Response to the Discussion Paper: The case for a better functioning securitisation market in the European Union

On behalf of the Association for Financial Markets in Europe ("**AFME**")[1] and its members, we welcome the opportunity to respond to the discussion paper (the "**DP**") entitled "The case for a better functioning securitisation market in the European Union" published by the Bank of England (the "**BoE**") and the European Central Bank (the "**ECB**" and, together with the BoE, the "**Central Banks**") and finalised on 29 May 2014.

AFME and its members would like to thank the Central Banks for producing a carefully thought-out and constructive discussion paper. Even though many discussion papers and consultation papers on individual pieces of legislation and policy affecting the securitisation markets have been published over the last several years, the DP makes a particularly worthwhile contribution because it examines the broader landscape and contributes significantly to encouraging the creation of vibrant, meaningfully reformed securitisation markets as a tool for funding the real economy. Although it has been apparent for some time that policy-makers within the European Union have recognised the positive impact securitisation can make market participants are very encouraged that the Central Banks have taken this concrete step to identify the factors preventing a revival of a sustainable securitisation market and to address the relevant impediments.

It is also worth noting that the DP is perhaps the most evolved attempt thus far to bring together disparate conversations that have been taking place about the concept of "high quality" or "qualifying" securitisation, how it should be defined and the consequences of falling in (or out) of such a classification. While it has been useful to date for that conversation to be wide-ranging and inclusive, it is necessary

1 AFME represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1 November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association. AFME provides members with an effective and influential voice through which to communicate the industry standpoint on issues affecting the international, European and UK capital markets. AFME is the European regional member of the Global Financial Markets Association (GFMA) and is an affiliate of the US Securities Industry and Financial Markets Association (SIFMA) and the Asian Securities Industry and Financial Markets Association (ASIFMA). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

in order for it to bear fruit that discussions should be brought together in a forum that is capable of producing credible policy proposals with the necessary political backing to produce real outcomes in a relatively short timeframe. The forum created by the Central Banks via the DP is clearly very helpful in this regard.

Finally, AFME welcomes the IOSCO and the Basel Committee on Banking Supervision market survey on broadly similar themes to those touched on in the DP, albeit at a more general level. We believe both exercises are beneficial, with the DP more likely to produce concrete results in Europe in the near to medium term and the IOSCO/BCBS survey likely to influence the long term direction of regulation at a global level.

Our substantive response consists of overall comments, followed by our answers to the 18 specific questions posed by the DP. The annex hereto contains our detailed thoughts on the proposed criteria set out in Box 3 of the DP for determining whether a particular transaction is a "qualifying securitisation". Should the Central Banks wish to discuss any aspect of our response in further detail, we would be pleased to arrange this.

A. Overall Comments

As a general matter, AFME and its members agree with the analysis presented by the Central Banks in the DP. We believe it effectively sets out the principal benefits of a well-functioning securitisation market and the principal impediments to the development of such a market.

It is, of course, important to AFME and its members that this important work being undertaken by the Central Banks should be coordinated with other workstreams already in existence. Not least of these are EIOPA's development of level 2 standards under Solvency II for investments by insurance undertakings, the workstreams of the EBA on defining "high quality securitisation" and on the recognition of significant risk transfer in securitisations, continuing analysis of the eligibility of securitisations as HQLA in the LCR and the ongoing revisions to the Basel Securitisation Framework by the Basel Committee on Banking Supervision (and the EU's eventual implementation thereof) and the FSB's ongoing work on shadow banking (and its securitisation workstream in particular). If the thinking developed via the DP and the responses thereto is to be effectively implemented, the themes developed will need to feature in the final rules resulting from these workstreams (among others) as well.

AFME and its members also agree in broad terms that defining a sub-category of securitisations for differential treatment on the basis of transparency and predictability (which, for the sake of simplicity, we will call "qualifying securitisations" or "QS", though please note our comments on the neutrality of terminology below) would be a helpful development. Indeed, the objectives and the achievement of the joint work undertaken from 2009 to 2012 by the European Financial Services Round Table ("**EFR**") and AFME to develop and launch the European Prime Collateralised Securities ("**PCS**") label were based on and consistent with this principle. Further thoughts on this are reflected in our detailed responses below, but we feel it helpful to outline the broad features that we feel are important to make the most of this development:

a) The first of these features is that the language used to describe qualifying securitisations should be as neutral as possible. In this respect, we find the Central Banks' use of the term "qualifying securitisation" preferable to the more broadly used term "high quality securitisation". AFME would recommend, however, that this principle be taken even further (resulting in an approach not unlike the proposed EIOPA terminology) and that the labels attached to the different kinds of securitisation be along the lines of "category 1" and "category 2" or "category A" and "category B". This would preserve the ability of regulators and market participants to quickly and easily distinguish between qualifying securitisations and others, which is the key policy driver behind the suggestion. It would also avoid the potential pitfall of the "high quality securitisation" approach which may implicitly shift the burden of stigma from the securitisation market as a whole onto that sector of the market which would fall outside the definition of "high quality securitisation" and hence by implication become "low quality" or "non-qualifying" securitisation even when the actual assets in the ineligible securitisation could not be regarded as problematic or poor quality. A further benefit would be to increase the level of market support for the creation of a qualifying securitisation category because those parts of the market that might not be eligible for better regulatory treatment would be less inclined to oppose it.

b) The second key positive evolution in the Central Banks' proposals for qualifying securitisations as compared to previous proposals is the Central Banks' transaction-based approach. Previous proposals have almost uniformly been tranche-based, with only the most senior tranche of any given transaction being allowed to qualify. This tranche-based approach implies that the purpose of qualification is to reduce or eliminate risk. One of the chief virtues of the Central Banks' proposals is their focus on transparency and the ability to understand and model risk, rather than an attempt to reduce or eliminate risk. The function of any efficient market is to price and allocate risk, not to eliminate it. In the case of the securitisation markets, the risk that ought to be priced and allocated is the credit risk of the underlying assets, as modified by the structuring of the transaction (via tranching and credit-enhancements such as swaps and liquidity facilities). It follows that investors need the information necessary to properly assess those risks and their ability to bear them so they can price the risk accurately. That makes requirements relating to simplicity, loan-level data and general ability to model the risk sensible and appropriate. Qualifying securitisations should not be risk-free, and should not give the impression of being risk-free. Rather, the badge of "qualifying securitisation" ought to represent a belief that the risks are capable of being modelled reliably by the targeted investor base using the information made available to them.

Finance for Europe

c) The third broad area on which AFME and its members wish to comment is to note that the term "securitisation" used in its CRR sense, is a very broad term and the criteria suggested, while broadly sensible, do not always take full account of this. An example of an important area that may not have been given full consideration by the Central Banks is asset-backed commercial paper. Although ABCP conduits are "securitisations" in the regulatory sense, they do not fit the paradigm of a securitisation we imagine the Central Banks will have had in mind when developing the criteria in Box 3. As a result, ABCP would not be a QS under the Central Banks' proposals despite the fact that it delivers many of the benefits of securitisation outlined in the DP (e.g. funding trade receivables and other real economy assets, diversification of funding sources for non-bank clients and warehouseing of assets for later ABS transactions), its robust structure (featuring, e.g. significant overcollateralization and retention by originators of a dynamically adjusted first-loss tranche) and the fact that most conduits are supported by strong sponsor banks. The definition of "securitisation" has long caused problems of this sort, so adjusting that regulatory definition may be the most sensible solution to this issue. Alternatively, AFME would urge the Central Banks to adjust the criteria to recognise positively the special structural considerations associated with the ABCP market.

d) The fourth key aspect of an effective regime for qualifying securitisations is that there should be certainty surrounding the categorisation of each transaction. Given the importance of the mooted effects of being a qualifying securitisation (or not), parties to a securitisation transaction need to be able to have a high degree of certainty early on as to whether the transaction is likely to fall within that category. This will affect structuring, marketing and a host of other matters that become much more difficult and costly to change after the initial steps of putting together a transaction have taken place. Equally, it is crucial that investors know early in the investment decision process whether they are reviewing a qualifying securitisation or not and that they should be able to rely on that categorisation absent a subsequent change in the transaction itself (e.g. the failure of the transaction parties to provide ongoing asset disclosure).

e) The fifth key aspect of an effective regime for qualifying securitisations is that determinations should be timely. The categorisation process should not unduly delay the overall issuance process and it should be clear at the beginning of the marketing process for any securities whether a securitisation will be a qualifying securitisation or not. To draw an analogy, at the moment, it can sometimes take up to several weeks after issuance before it becomes clear whether a securitisation will be accepted as eligible collateral for the purposes of either of the Central Banks' liquidity operations. This is not helpful, so if the concept of qualifying securitisations is to have an effect on marketing, pricing and initial liquidity of an instrument, it must be clear based on formal feedback from the certifying body that it will be a qualifying securitisation prior to the marketing process. In this context, we would note that if private sector involvement in the administration of QS were to be adopted by the relevant authorities then it would be relevant that this is how the PCS scheme currently operates and we understand that the infrastructure that it has in place for certifying compliance with PCS criteria could readily be adapted to the proposed criteria for QS in the DP.

In order to address points (d) and (e) above, AFME recommends as a general matter that the criteria should be clear and precise so that, so far as possible, a "tick box" approach to compliance can be used. Clearly, a level of discretion and judgment will be required in order that any new innovation in the securitisation market should not immediately cause transactions to fall out of the category of qualifying securitisations.

AFME would urge the Central Banks to bear the above in mind when formulating a mechanism for categorisation of transactions. See our response to question 7 below for more detail on this point.

B. Answers to Specific Questions

1. Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?

Yes, we believe the benefits outlined are comprehensive and thoughtful.

Paragraph 37 notes the relatively short maturities of market-placed ABS. The European ABS market is of course almost entirely floating-rate. It is difficult to place bonds with maturities of more than say, a weighted average life of 7 years with bank or other funded investors as their risk appetite tends to peter out beyond this maturity. From a structural point of view, creating a fixed rate issue with predominantly floating rate assets (as most European assets are, ultimately) is difficult outside master trusts, which in turn place heavy reliance on substitution. The reduced availability and increased cost of interest rate and currency swaps further reduces structuring flexibility. Increasing insurer investment appetite is probably more easily achieved by going down the credit spectrum than by seeking to create a fixed-rate market.

Paragraph 39 Encumbrance: it is particularly encouraging to see this noted as a “benefit” of (or being less significant for) securitisation as we believe this positive aspect of securitisation as a technique is not sufficiently noted by regulators.

Paragraph 50: we agree that different objectives may require different market characteristics. AFME is in favour of a “modular” approach to the definition of “qualifying securitisations”, namely a “core” definition comprising key principles, to which could be added additional requirements or "filters" intended to address specific requirements. For example, an entire transaction might qualify as QS but only the senior tranche would qualify as being HQLA under the LCR.

2. Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?

Broadly, yes. We believe the paper identifies the key impediments which are also listed in AFME's June 2014 paper: "High quality securitisation for Europe: the market at a crossroads." We are encouraged by the progress that has been made to date in the discussions around Basel 269, Solvency II and (we hope, although official information has not been published) the inclusion of a wider range of securitisations than just some forms of RMBS as HQLA in the LCR.

Paragraph 74 risk retention: this rightly identifies inconsistent implementation of risk retention requirements across jurisdictions. However, impediments also exist within the EU but across different types of investors, for example between the CRR rules for bank investors, the AIFMD rules for AIFMs and the Solvency II rules (still relatively nascent) for insurers. There is no sensible reason why these could not be made entirely consistent save for adjustments necessary to reflect the unique characteristics of the different types of investors involved. Please refer to AFME's "Initial response to EBA questionnaire on the securitisation risk retention, due diligence and transparency requirements" dated April 22nd 2014 for more detail on this point.

Paragraph 77 behavioural constraints: this again makes a good point. Within investor firms, greater participation in securitisation investment has been far from a career-enhancing recommendation in recent years. The stigma needs to be removed and replaced by more positive signalling. This is beginning to happen and the recent announcement by the ECB of their consideration of an ABS purchase programme will no doubt help in this regard (even if there are some longer term reservations about the possible "crowding-out" effects).

Paragraph 78 risk assessment and management: it is axiomatic that securitisation is (and should be) a data-rich form of investment.

Indeed, standards of disclosure have always been very good in mainstream securitisation. Problems emerged during the crisis in CDOs: drilling down into the underlying data of dozens of different ABS issues was not possible – or practical – encouraging over-reliance on credit ratings. AFME's members support sensible, useful and practical disclosure in compliance with the Prospectus Directive, the CRR and other applicable legislation. However, over-emphasis on "transparency" as the single answer to the industry's problems – especially repeated new transparency regulation of areas already regulated for transparency - can risk diverting attention from other issues holding back the market.

Information disclosure has also increased markedly in recent years: ECB and Bank of England loan-level data requirements; investor reports, cashflow models and transaction summaries; underlying legal documentation (suitably redacted to protect reasonable commercial confidentiality); CRR requirements supported by EBA "principles-based" guidance.

However, rather than repeated new regulation from different sources, we believe future attention in this area should be focused on improving compliance with and consistency of existing requirements; improving the quality of data, not just the quantity; making the data already available more "user-friendly" for investors; and facilitating, rather than hindering, cross-border flows between regions, through mutual recognition or substituted compliance of loan-level data templates and other requirements.

Paragraph 82 long-dated fixed or predictable cashflows: this can prove challenging – see the structuring challenges listed in the answer to question 1, Paragraph 37 above.

The newly announced TLTRO is the latest proposal that industry fears could have the unintended consequence of reducing issuance even further with the knock-on effect of discouraging the entry of new investors who will not commit resources for investments in a tiny market. Established investors may also consider exiting the market for the same reason.

A final impediment to the development of sustainable securitisation markets is capital treatment and the lack of a level playing field between investors in the current legislative proposals. Capital treatment of securitisation investments is clearly a major factor in investment decisions. Despite some progress, both the latest proposals for a revised Basel Securitisation Framework and the proposed treatment of securitisations under Solvency II remain unfairly punitive and create an unlevel playing field both between different kinds of investors and between different kinds of assets with similar credit risk.

3. *Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?*

Broadly, yes. We believe the paper identifies the key impediments.

Paragraph 89 reliance on CRAs: See answer to question 13 below.

Paragraph 91 availability of ancillary facilities: on swaps, it is critical that an appropriate exemption is created for securitisation swaps (as it has been for covered bonds) in EMIR. This is an issue which AFME is addressing in detail in its response to the joint ESAs consultation on draft Regulatory Technical Standards on risk-mitigation techniques for OTC-derivatives not cleared by a CCP under Article 11(15) of Regulation (EU) No 648/2012 which has significant implications for swaps entered into in connection with securitisation transactions. Responses are due by July 14th 2014.

On issuer accounts and GICs: To the extent it is practical and the cost of implementing it is proportionate in the specific jurisdiction, any specific legislation to facilitate the creation of bankruptcy-remote accounts would be of great assistance. It would reduce legal uncertainty, help simplify structures and lower required enhancement levels thereby increasing the attractiveness of securitisation for both investors and issuers. The recent changes made in Italy and France in this context are instructive, as is the US concept of segregated trust accounts in a bank's trust department.

Paragraph 92 alternative funding conditions: while the reasons for the official sector schemes are understood, and are driven by wider macro-economic policy objectives, their effect in dampening securitisation issuance should not be underestimated. Funding and capital pressures will only intensify if a framework to encourage the recovery of securitisation in Europe is not in place in time to play a larger role, as such schemes are withdrawn.

4. Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

We believe the question should be read as asking "Do respondents agree that the *absence of* market liquidity may be a barrier to a well-functioning securitisation market?" If so, the answer is no.

As AFME has argued many times in the context of the LCR, liquidity is not the same as secondary trading. The securitisation market may function perfectly well with relatively little secondary trading and still be liquid in the sense that assets can be converted into cash in a short (say, 30 day) period if this is required.

A number of regulators have disagreed with AFME over this issue in recent years, citing the financial crisis and SIV unwind as evidence of the fact that securitisation is a fundamentally illiquid product. Much can be said in response to this view: selective use and partial interpretation of data, failure to take into account institutional support for secondary trading in certain other fixed income sectors, and so on. At the end of the day, during the deepest phases of the financial crisis, high quality short-dated ABS not linked to mortgage risk was one of the easiest asset classes to sell. See "AFME briefing note on market behaviour and securitisation price volatility" dated March 2014 for further comment on this topic. Also, Perraudin "Covered Bond versus ABS liquidity" (January 24th 2014) and "High quality securitisation: an empirical study of the PCS definition (May 2014) available here

5. The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

See overall comments above and the annex to this letter.

6. *Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?*

A "liquid market" is difficult to define, and in any event it is difficult to predict the future. As stated above, a "liquid market" is not necessarily the same thing as a market in which frequent secondary trading occurs. Many investors in European ABS are buy and hold investors, who are not concerned by the need to trade their investments actively. Having said that, even buy and hold investors need access to liquidity to protect them from market volatility during stressed market conditions. Considerable assistance in the recovery of the market in this regard would be provided by a positive outcome in the treatment of ABS under the LCR (at the time of writing this remains uncertain). If, as AFME has consistently argued for many months, a broad rather than a narrow range of high quality, or qualifying, securitisations were included as HQLA in the LCR, a virtuous circle would be created and more active trading could result. In a similar vein an ABS purchase programme for qualifying securitisations with the Central Banks acting as "purchasers of last resort", could underpin banks' market making activities, sending a powerful message to encourage more active participation in the market. After all, the bulk of losses on European securitisation incurred during 2007-08 were due to mark-to-market requirements rather than actual credit losses.

7. *These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?*

AFME very much welcomes the interest of the authorities in developing a framework based on defined principles of QS. It is crucial for industry and policymaker discussions of the concept of QS to converge in a single forum, where we can all work together constructively in a co-ordinated way. The objective will be to reach an agreed standard that can be applied widely, usefully, easily and clearly to help revive the market.

We suggest the authorities first appoint a single regulator or supervisor to lead and co-ordinate the work (for example, the EBA – who have already begun this work). Secondly, such lead authority should engage widely and extensively with issuers, originators and sponsors as well as investors, underwriters and important third party advisers such as law and accounting firms. If it would be helpful for AFME to establish a small technical working group selected from its members and reflecting the diversity of our membership to assist in these discussions we would be delighted to do so. This need not, of course, rule out selected bilateral discussions that the lead authority might wish to initiate. Thirdly, we suggest that a timetable should be established with a target date for conclusions to be reached, and regular meetings scheduled to achieve this. Discussions should use as a good starting point the criteria developed by EIOPA in its December 2013 report.

In terms of a role for the authorities, it is suggested that the authorities should play a supervisory role in determining the criteria for a QS, and then appointing and regulating one or more independent, credible bodies to issue certifications. A number of bodies already exist to assign similar labels in the debt capital markets. To the extent that they are willing and able to administer the criteria for qualifying securitisations eventually decided upon, they are natural candidates to act as certifying bodies. Of these bodies, the PCS label is the only Europe-wide securitisation label and resulted from the work undertaken from 2009 to 2012 involving a broad range of European market participants (arrangers, originators, investors and legal experts) led by EFR and AFME. As such, and also because PCS has been designed to be responsive to the needs of issuers and investors in terms of giving certainty around the receipt of the label for marketing purposes (as mentioned above), PCS is an obvious and strong candidate to act as a certifying body. True Sale International (TSI) and the Dutch Securitisation Association (DSA) are other securitisation labels but currently only have a national scope. The lead regulator should also play a supervisory role, reviewing the criteria regularly to adapt to market evolutions, ensuring that standards are applied uniformly and regulating the conduct of the certifying bodies generally.

Regarding the risks: much work remains to be done, and there remain difficult challenges to resolve – for example, how to avoid cliff effects; how to address the different motives and requirements of different stakeholders; and how to strike the right balance between meeting the needs of the real economy while maintaining high quality. There will also be a need to avoid political interference: the history of the growth of the sub-prime mortgage market in the US is instructive in this regard. It needs to be very clear that the definition of QS is not a "badge of regulatory approval" or a rating, and that it should not be used as a substitute for proper due diligence and credit analysis.

8. *Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?*

AFME believes that harmonisation of data templates and formatting would be a positive development. Investors frequently point out to us that while it is useful having loan-level data available from the European DataWarehouse or the Bank of England, the data is not always available in a user-friendly format. The differences (IT, technical and in substantive content) between the two platforms are also not helpful and it is good that this is noted in your paper. We have also heard that technical difficulties have sometimes resulted in data being corrupted when being uploaded to the European DataWarehouse.

Clearly, more work needs to be done to resolve these practical and technical issues, and perhaps further discussion is required around the incentives necessary to encourage private-sector solutions to the absence of user-friendly software to assist in the ease of digestion, and proper understanding, of data.

9. *Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?*

Cash securitisations have to be structured around the cash flows of the securitised assets, the needs and capabilities of originators and their systems, and commercial terms. There will therefore always be natural limits to the degree of standardisation that can be achieved.

Commercial pressures have already produced considerable standardisation of transaction structures and documentation - neither issuers nor investors seek inconsistency for its own sake.

Standardisation should not lead to "box-ticking", detract from the need for sensible flexibility (the "comply or explain" principle), unreasonably restrict the freedom of commercial parties to agree suitable terms or unreasonably restrict the choices of consumers.

Having said that, we agree that further simplifying work could be undertaken regarding prospectuses and investor reports. However, a balance will need to be struck between the need to achieve greater standardisation (and simplicity) on the one hand and the legal obligation to make appropriate disclosure under the terms of applicable legislation on the other.

Securitisation is captured under the new transaction reporting and pre- and post-trade transparency requirements for fixed income under MiFID II. Following implementation of these requirements, there will be a high-level of European-wide harmonised public trade transparency in the securitisation secondary markets.

We also agree that, provided the cost is proportionate, having prospectuses and investor reports collected in a single repository would be a useful evolution. It seems to us, however, that such a repository is already being considered in the form of the website to be established by ESMA under Article 8b of the Credit Rating Agencies Regulation.[2] To the extent that a single repository is created under that regime, it should be coordinated with the single repository suggested by the Central Banks in the DP so as to avoid duplication of efforts.

10. *Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?*

Yes, facilitating access to such data for certain asset classes such as loans to SMEs or certain types of leasing transactions would make securitisation of these assets

2 In this respect we would note that AFME and its members still have significant concerns with the Article 8b regime. These have been summarised in the AFME response (dated 10 April 2014) to ESMA's Consultation paper on CRA3 implementation – Draft regulatory technical standards on information on structured finance instruments (SFIs), available here.

easier. See "ABLe – an agency for business lending", a report prepared by AFME for the UK Department of Business Skills and Innovation in October 2012.

For other asset classes such as residential mortgages, auto loans and leases, consumer loans and credit card receivables we believe that the credit data available already is sufficient, although we note the importance of harmonisation of reporting regimes in this respect.

Preserving borrower confidentiality is challenging, and has been a difficult issue to resolve in the context of the existing ECB and Bank of England loan-level data templates. The solution adopted has been to anonymise or disguise data in various ways: for example, not just by hiding borrower names but also by truncating postcodes, approximating up or down amounts outstanding, etc. The legal requirements which need to be satisfied vary from one country to the other, but in the UK (for example) the key criterion is the extent to which the information published, *when read with other data already in the public domain*, could cause a breach of confidentiality. Given the severity of the sanctions on originators for breach, both legal and reputational, this is a difficult issue.

AFME does not believe that credit registers would be helpful for asset classes other than SME loans. Data on underlying obligors is already reported by transaction parties and creating another source for the same data would not produce benefits commensurate with the cost of establishing credit registers. Rather, it is important to simplify and harmonise the formats in which information is reported to ensure it can be easily analysed and compared by investors.

11. In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

We believe that sufficient macro-economic data is already available from many sources, including from originators, the rating agencies and other sources.

Much securitisation-specific data is of course already disclosed pursuant to the existing ECB and Bank of England requirements and European DataWarehouse. Article 8b of the Credit Rating Agencies Regulation contemplates further similar (and in some cases overlapping) disclosure. In principle, a single repository for relevant data would be helpful to all market participants: to issuers and originators by reducing costs and removing overlapping compliance and filing requirements (thereby making securitisations easier to execute), and to investors and credit rating agencies in providing a single source of information for their initial investment or rating decision as well as ongoing credit assessment. However, we are concerned by what appear to be competing initiatives in this area. We urge all the different authorities involved to focus on harmonising and simplifying both data reporting templates (where possible) and also formats (there seems to us no sensible reason for competing formats in data files, for example), so that information only needs to be submitted once, in one place and in a single format.

12. Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

It is possible that these could be helpful, but only if the relevant indices are supported by a meaningful volume of transactions that is characteristic of a liquid market. AFME would therefore recommend a "wait and see" approach in order to allow this to be assessed in the light of evolutions in the secondary market for securitisation assets following the implementation of any initiatives resulting from the DP.

13. Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

Overall, AFME members who are users of credit ratings believe that the publication of "uncapped" ratings would be a useful innovation because it provides useful information to investors about the quality of the underlying assets and the credit enhancement applied thereto.

This is clearly an issue for both the originator and the investor sides of the market. Some rating agencies impose ceilings on securitisation ratings that are derived from their rating on the relevant sovereign. These rating ceilings are intended to reflect certain “tail risks” associated with a potential sovereign default, and that cannot be mitigated e.g. by additional credit enhancement, in the agencies’ view. Many market participants, however, disagree with the agencies’ assessment of the scale of these risks and therefore with the calibration of these rating ceilings. This could be remedied in part by requiring credit rating agencies to publish "uncapped" ratings, which would allow investors to overlay their own view of such sovereign-related risks. This would, however, only be of limited usefulness because investors would presumably still be required to use the lower, capped rating e.g. for purposes of capital allocation.

It is also worth noting that pursuing this avenue would be a complex endeavour for credit rating agencies because it would require them to analyse every input of sovereign risk into the ultimate rating of the securitisation, e.g. in the rating of the counterparties. Harmonising this approach across rating agencies may be difficult, but would be necessary if the "uncapped" ratings are to be meaningful in the market.

That said, an obvious benefit of publishing the matrix suggested by the Central Banks would be to allow investors to readily distinguish between deals are structured to the relevant sovereign cap rating (which is commonly done because it is known that it will not be possible to achieve a higher rating in any case) from those structured to AAA level but rated lower because of a sovereign cap.

14. *How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?*

This is a significant issue in part because the cost of ancillary facilities is so high. These costs arise in part because of the contingent liquidity outflows arising from minimum required credit ratings for providers of ancillary facilities such as bank accounts and interest rate or currency swaps ("**Ratings Triggers**"). These Ratings Triggers typically require ancillary service providers to find a replacement provider or collateralise the relevant exposure if they fall below the required rating. In both cases, there is a contingent outflow that drains the provider's liquidity assets.

The cost of Ratings Triggers could be reduced (and thereby the universe of possible ancillary service providers presumably expanded) via adjustments to the LCR (e.g. reducing the factor applied to outflows for qualifying securitisation Rating Triggers to less than 100% or allowing greater amounts of qualifying securitisations as HQLA) or via more direct central bank support (e.g. allowing emergency funding drawing capacity to be allocated to qualifying securitisations or providing bank account and swap capacity directly to bank-sponsored qualifying securitisations).

This is also a significant issue particularly in jurisdictions where the sovereign cap is materially higher than the ratings of providers of ancillary facilities. In such jurisdictions the market expectation is that transactions will be rated at or, if possible, above the sovereign cap and reaching that rating level can therefore be challenging if the providers of ancillary facilities have materially lower ratings.

For certain categories of issuers, particularly large commercial banks with significant bank account business, the risk of losing cash collections can materially increase the operational inefficiencies of securitisation transactions and the cost of credit enhancement for the structure. Moreover, investor concerns around bank issuers (and negative rating agency assumptions) are exacerbated in times of financial stress as a result of such issues, thereby adversely affecting the effectiveness of securitisation as a counter-cyclical tool for bank issuers.

Given the pressure on counterparty ratings, and the small number of counterparties available, consideration should be given to a possible role for a suitably rated public sector entity to provide guarantees of swaps or other ancillary facilities. This is not without risk to the guarantor, and adjustments to mandates might be required, but the market impact of this type of public sector intervention could be considerable.

15. *With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?*

See the responses of AFME (and GFMA) to recent consultations of the BCBS and European authorities on capital, liquidity, risk retention and high quality securitisation, *passim*. Several of these are referred to in this paper and can be found at www.afme.eu.

16. Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

The recently announced (in principle) ECB purchase programme, if correctly structured and targeted to support qualifying securitisations, could provide a cornerstone to support market making by banks, re-building confidence and sending positive signals to the wider non-bank investor base. However, we would note that the purchase programme if not targeted properly risks "crowding out" investors from the market, in the short term as well as doing potentially permanent damage to private investment demand. In order to avoid that negative outcome, we would recommend designing the programme with one or more of the following features:

- make public placement of a minimum proportion of the securities an eligibility criterion for the purchase programme; and/or

- target some of the purchases at the mezzanine tranches of ABS transactions therefore limiting the impact of the programme on the availability of highly-rated ABS in the public markets; and/or

- place strict limits on the amount of ABS collateral that can be purchased so as to ensure continuing availability of ABS in the hands of private investors.

Otherwise the DP seems wide-ranging and comprehensive.

17. Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?

AFME believes that securitisation is the best way to achieve these benefits.

18. Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?

See annex.

afme/ Finance for Europe

In closing, we wish to emphasise that the engagement of the Central Banks with market participants on the revival of the securitisation market in the European Union is greatly appreciated. We hope this response in helpful. We are grateful for the opportunity to comment on the DP and we would be happy to answer any further questions that you may have or develop further issues of interest to you.

Yours faithfully

Richard H. Hopkin

Richard Hopkin, Managing Director
Association for Financial Markets in Europe

ANNEX

Feedback on criteria for qualifying securitisations (Box 3)

AFME believes that the principles set out in Box 3 are broadly sensible given the objectives set out in the DP. The principles are a good starting point but are, in many cases, very general and will need further refinement and specification in order to allow for predictability in the assignment of a QS certification. We have the following specific comments on the principles as set out in the DP:

Paragraph 128: This is broadly sensible, though we would note that derivatives should be acceptable in a qualifying securitisation to the extent they are present for hedging purposes. We would note further that many of our members see no reason why synthetic securitisations should necessarily be excluded from the qualifying securitisation category. They are important risk and capital management tools for AFME's bank members and, provided they meet the requirements of simplicity, structural robustness and transparency requirements imposed, a number of our members believe they should be eligible for QS. We note, however, that certain of our investor members have concerns relating to the control investors have over the underlying assets in synthetic securitisations.

Paragraph 129: This will be difficult to provide as proposed. In particular, consistent and comparable data will not necessarily be available because underwriting standards change over time. Requiring data over a long period of time means that assets with substantially different underwriting criteria would be compared without a practical way of reflecting the underlying differences in assets.

Paragraph 130: This is broadly sensible, although note our comments in respect of synthetic securitisations on paragraph 128. Also, some flexibility will be required in this criterion as concerns structures such as master trusts and originator trusts where the issuer will not necessarily have direct recourse to the underlying obligors.

Paragraph 131: Further guidance will be required on the meaning of "homogenous", but this criterion is sensible provided it is intended to refer to relatively high-level homogeneity (e.g. residential mortgages, rather than something as specific as, say, buy-to-let mortgages in the London market). Also, we wonder how an obligor's "volition" to make timely payments can be assessed beyond checking their having entered into a contract to do so (the asset sold into the securitisation). Is this meant to ensure that affordability has been checked?

Paragraph 132: This is again a broadly sensible criterion but needs to be addressed more specifically to exclude excessive reliance on market-based refinancing risk. For example, an RMBS is highly unlikely to have a life longer than seven years, but the underlying assets will likely have a WAL of 25-30 years. This is nonetheless acceptable because refinancing of residential mortgages is a normal feature in the life of the product and is highly unlikely to be problematic at a level that would impact the cashflows on the transaction in a material way.

Paragraph 135: See our comments on synthetic securitisations in respect of Paragraph 128. This is broadly sensible, but it should be noted that any legal opinion will be subject to customary assumptions and qualifications in respect of these items appropriate for the relevant market. These should not be a barrier to the transaction being a qualifying securitisation.

Paragraph 144: While we understand the reason for including this criterion, we question its appropriateness in all circumstances. Firstly, the direction of travel in financial services regulation generally (not just in securitisation) is to reduce undue mechanistic reliance by investors on external credit ratings through transparency - a principle we support. Secondly, a "one-size- fits-all" approach here may not be appropriate: in private transactions (for example) the transaction parties may wish to make their own arrangements for ongoing credit assessment: this may be "independent" or not, and may involve an ECAI or not. It is important to note that recent legislation in the form of Article 8c of the Credit Rating Agency Regulation does not mandate the involvement of at least two ECAIs for all issues of structured finance instruments; it simply requires two ECAIs if the transaction is rated at all. To require two ECAIs in order to qualify as QS seems to us to widen this legislative requirement "by the back door" – at least at the "core" level of any QS definition. Of course it may be sensible at a "modular" level (for example, additional requirements for central bank repo eligibility) for a dual ECAI requirement to apply. There is detail and subtlety here which requires further discussion.

Paragraph 146: We are not clear as to the intended meaning of this requirement. If it is a requirement for an audit of the reports from the transaction, we are unsure whether auditing firms would be willing to provide this or what value this would add

AgFe

AgFe Response to:

The case for a better functioning securitisation market in the European Union

A Discussion Paper

BANK OF ENGLAND

EUROPEAN CENTRAL BANK
EUROSYSTEM

4th July 2014

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Section A: Summary Response to the Discussion Paper

The post-crisis era has seen increased regulation of three key securitisation market participants. Regulation of issuers has focussed on retention requirements and transparency/minimum disclosure requirements whilst that of rating agencies has centred around conflicts of interest and inappropriate alignment of incentives. In light of the above, we feel the new regulations on investors are unduly onerous, especially those relating to higher capital charges and requirements to perform detailed credit analysis prior to investing – which is impeding the recovery of the market.

The benefits of a well-functioning securitisation market depend largely on the nature of participants and distributions of benefits among them. It is beneficial to institutional borrowers if good pricing is achieved which in turn, depends on the risk-return trade-off for investors in light of the headline and regulatory risks which have become associated with securitisation. With that in mind, we feel investor participation has been impaired by a combination of higher capital charges for securitised bonds which are especially punitive compared to similarly rated corporate or covered bonds, negative media perception/comments from regulators and increased regulatory uncertainty in this sector. We are aware of institutions that have taken a strategic decision to cease any involvement in the market to save time and resources spent in dealing with the above factors. The difference in regulatory vs. accounting treatment and difference in regulations within EU vs. the US has added to the market friction. Moreover, the regulatory capital treatment of ancillary services such as swap facilities discourages bank participation as swap counterparty, thereby acting as an impediment to risk transfer securitisations (though funding securitisations may remain attractive). It is important to note that another reason for assets not providing sufficient yield for securitisation deal economics to work, is that the availability of ultra-cheap funding from central bank facilities has distorted pricing incentives and so indirectly renders securitisation an unattractive/unviable funding option.

The self-fulfilling perception of illiquidity may contribute to market dislocations and may itself be a consequence of regulatory changes. In particular, secondary market liquidity is affected as the economic incentives for broker-dealers have changed and their involvement in the market is no longer as attractive which may in turn affect primary market liquidity.

In response to specific proposals in the consultation paper, we have reservations about the proposed definition of a 'qualifying securitisation' (see detailed response to question 5). Moreover, we consider that the mere application of such a label is unlikely to have a materially positive impact on market liquidity. Instead it carries a number of potential drawbacks such as investors discriminating against all other transaction types, the proposed framework duplicating the work of rating agencies, moral hazard problems and a reduction in diversity of views thereby increasing systemic risk.

Regarding the provision of loan-level data, we doubt that there are either resources or substantial appetite in the investor community to carry out such detailed analysis; hence we regard it as unlikely that the provision of incremental data would materially contribute to a better functioning securitisation market. Moreover, provision of more credit data would only benefit larger incumbent investors with the resources and scale to take advantage of the information. Neither of the proposals addresses the issue of lack of excess return that would justify the additional resources required for such analysis.

While standardisation of documentation and transparency of reporting are beneficial to investors, we would caution that this needs to be weighed against the potential burden on issuers/sponsors.

In our view, a revival of a well-functioning securitisation market will require a broader distribution across a diverse investor universe which would contribute to increased liquidity in the market. This would require the participation of investors taking smaller positions, which is currently rendered economically unviable owing to the cost burden of additional analysis and diligence required under current regulations. Participation of such investors is only viable if they can outsource their diligence and analysis to rating agencies. Moreover, the status quo benefits the market position of large institutions with economies of scale to perform such detailed analysis. A reduction in barriers to entry on investment should allow for a broad investor base and reduce risk concentration whilst facilitating a revival of a well-functioning securitisation market.

Section B: Detailed Response to the Discussion Paper

General Background

As general background to our responses to the questions below, we briefly summarise our views on the obstacles to revival of the European securitisation market.

The post-crisis reforms to the regulation of securitisation have generally been of three types:

i. Regulation of issuers
ii. Regulation of rating agencies
iii. Regulation of investors

The impact of the regulation on issuers has primarily been in relation to retention requirements and transparency and information provision, the aim being to ensure that there is an alignment of interests between issuers and investors, and to ensure that there is adequate disclosure for investors (and rating agencies) to be able to form their own views about the characteristics of issued securities.

The regulatory reforms of the rating agencies have been made to ensure that there is minimal risk of conflict of interest within rating agencies so that they are not inappropriately incentivised. This has included their regulation by ESMA and the extensive disclosure requirements they are now required to follow.

The regulation of investors has both qualitative and quantitative components, with the quantitative aspect being dominated by the regulatory capital treatment of securitisations (i.e. Solvency II and Basel 3/CRR/CRD 4). One aspect of the qualitative treatment includes the potential treatment of securitisations under the LCR for banks which is still a matter of discussion. The other main qualitative aspects are the requirements that investors carry out their own credit analyses of securitisations and not solely rely on the ratings (e.g. CRD 2, 122(a) and equivalent language expressed elsewhere in other legislation).

If there had not been the reforms to the regulation of issuers and rating agencies, we would be more sympathetic to the need for the regulation of investors to reduce their reliance on ratings and to require them to undertake detailed analysis. However in the presence of the reforms that have been implemented for issuers and rating agencies whereby the risk of perverse incentives for either party is substantially reduced, and hence many of the circumstances which have historically caused problems for investors being mitigated, we believe that it is unduly onerous for investors to have to carry out their own detailed work in most cases.

For a revitalisation of the securitisation market to occur, there would need to be broad distribution across a wide investor base which would contribute to increased liquidity in the market, and this in turn, we expect, would provide a positive feedback-loop in the sector. Greater liquidity would likely encourage wider investor participation, thereby increasing liquidity. However, many such investors might only be interested in purchasing relatively small positions, for which the incremental returns available over other comparable asset types would not be sufficient to cover the cost burden of analysis and due diligence consistent with current regulation. For such investors, the only viable approach would be to rely heavily on ratings – in essence such investors need to collectively outsource much of their due-diligence and credit analysis to the rating agencies. Absent the ability to do this (and currently it is, at the very least, strongly discouraged by regulation) their participation in the sector is unlikely to be economically viable. It is worth noting, in passing, that very large buy-side institutions may prefer the status quo as the current framework prevents competition from smaller firms which lack the economies of scale to buy transactions in volumes which would justify the cost of detailed credit work. This restricts the participation of smaller investors in the market, and hence maintains the larger institutions' buying power advantage.

We believe that for a revitalisation of the securitisation market to be successful, a wide universe of smaller investors would need to be encouraged to return to the market. For this to happen:

i. Securitisation would need to be de-stigmatised; this requires repeated positive public statements to this effect by policy makers, regulators and legislators
ii. The qualitative obligations placed on investors would need to be reassessed substantially
iii. The regulatory capital treatment would need to be reassessed in order for investment in the securitisation to not be more cumbersome and costly than that required for investments in corporate bonds and covered bonds.

Responses to Specific Questions

1. Do respondents agree with the benefits of a well- functioning securitisation market as outlined in Section 2?

Relevant Sections/Paragraphs: Section 2

The potential benefits of a well-functioning securitisation market depend to a significant extent on the nature of the investors supporting such market, as well as the benefits accruing to them. Broadly speaking, the universe of potential investors in securitisations can be categorised as follows:

i. European Investors
   a. European Banks
   b. European Insurance Companies
   c. European Pension funds
   d. Other European Funds (UCITS or AIFMD)

ii. Non-European Investors
   a. Non-European Banks
   b. Non-European Insurance Companies
   c. Non-European Pension Funds
   d. Other Non-European Funds

For institutional borrowers, a well-functioning securitisation market may provide access to funding and/or risk transfer at attractive levels, but this is contingent on the presence of investors willing and able to price securities at such levels. These investors will inevitably consider investments on the basis not only of their risk/return characteristics, but also on the headline risk, regulatory burden and regulatory risk associated with them. These latter qualitative factors will influence the return required by the investors, and hence determine the degree to which institutional borrowers can access the market on acceptable terms.

It should be borne in mind that for a well-functioning market to exist there will need to be some sectors of the investor universe for whom the exposure has desirable characteristics. Considering the categorisation of the potential investor universe listed above, it is possible to understand that whilst there might be sound reasons for investment in securitisation to be discouraged or constrained for several specific categories, the aggregate impact may be to affect the viability of the market as a whole.

2. Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?

Relevant Sections/Paragraphs: Paragraphs 72-82

The impediments and concerns identified reflect some of the issues which are relevant to investors in the context of securitisations, but not all of them. As mentioned above in our general comments, there are additional points, especially with regard to independent analysis and due diligence obligations.

Impact of the behavioural constraint (77) not to be under-estimated, especially given the stigma derived (in part) from pejorative comments that have in the past been made by regulators, policy-makers and legislators regarding securitisation.

CRD 2, 122(a) due diligence & analysis requirements render securitisation investment economically challenging due to the disproportionate burden of analysis required for a potentially small investment (as compared to, for example, a rated corporate bond or covered bond).

Latest Solvency 2 technical standards are punitive for all types of securitisations compared to similarly rated corporate bonds or covered bonds, although we appreciate that these proposals may still be under consideration.

The perception that the regulatory burden discourages other investors from participating in the market, itself leads potential market participants to doubt the availability of liquidity and hence reduces both investor demand and issuance volume, which in turn may contribute to reduced liquidity.

The recent rules governing what may be regarded as a 'matching asset' for long-dated liabilities (under Solvency 2) do not appear to be favourable for such a treatment being applied to securitisations, and, as such, it is doubtful to what extent the structuring solutions alluded to in (82) could, in fact, be achieved.

The high degree of uncertainty and flux surrounding the regulatory treatment of securitisation, which has been pervasive for much of the past 5 years and which shows little sign of abating, discourages institutions from making any long-term plans regarding investment in securitisation, including staffing of teams with the skills to participate in the market. We are aware of institutions that have taken a strategic decision to cease any involvement in the market simply to avoid wasting management time or resources attempting to determine how best to address the stream of consultation documents and changes.

3. Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?

Relevant Sections/Paragraphs: Paragraphs 83-92

The changes to rules governing the regulation of credit rating agencies have made it considerably more challenging for issuers to engage effectively with the credit rating agencies on developing transaction structures; this may limit the ability to innovate in the sector.

The differences between the reporting, retention and regulatory requirements in different jurisdictions (in particular the US versus the EU) can give rise to concern about incremental costs.

The interplay between retention requirements and IFRS accounting requirements may make it challenging for issuers to achieve attractive treatment on a regulatory basis for risk-transfer transactions carried out though cash securitisations (as opposed to synthetic transactions).

The changes in regulatory treatment for swaps and liquidity facilities make the provision of these ancillary facilities less efficient, and hence discourage banks from providing them. Further, their provision by the issuer/sponsor may have adverse consequences for the regulatory or accounting treatment under some circumstances. As a result, the expense of providing these facilities mitigates against them being provided by third party institutions, and hence discourages risk-transfer securitisations, although funding securitisations where the issuer/sponsor provides these, may remain attractive. This phenomenon also may discourage non-bank issuers/sponsors from entering into securitisation transactions, since they may not be in a position to provide these facilities themselves. It should be noted that in the US, "Servicer Advances" appears to serve a similar role to liquidity facilities, but may benefit from less onerous regulatory treatment.

4. Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

Relevant Sections/Paragraphs: 93-94

The perception of market illiquidity certainly may contribute to a poorly-functioning securitisation market. However, as mentioned above, this self-fulfilling perception may itself be the consequence of certain aspects of regulatory policy.

However, it may be worth considering the distinction between the primary market (for the placement of new issues) and the secondary market (for subsequent trading). It is certainly the case that the absence of a dynamic secondary market can impair the performance of a primary market; this is one of the reasons why broker-dealers have historically provided secondary market liquidity. It is possible that the increased regulatory pressure on trading book capital has contributed towards discouraging broker-dealers from providing secondary-market liquidity, and this in turn has contributed towards weaker investor appetite in the primary market.

Another reason why broker-dealers may be less motivated to provide secondary-market liquidity is that the revenues available from arranging and distributing primary-market transactions might be insufficient to motivate them to devote resources to the sector. Issuers/sponsors of transactions may have grown used to structuring securitisation transactions themselves, retaining significant parts of the capital structure rather than having the notes broadly distributed, and as a consequence paying minimal fees to broker-dealers.

Despite this, there is no prima facie reason why poor secondary-market liquidity should directly impact on primary-market liquidity. However, the indirect factors may be significant in view of the increased premia that primary investors may demand in light of the expectation of weak secondary-market liquidity.

General comment in response to paragraph 95:

It could be argued that one of the reasons for assets not providing sufficient yield for securitisation deal economics to work, is that the availability of ultra-cheap funding from central bank facilities has distorted pricing incentives and so indirectly renders securitisation an unattractive/unviable funding option.

5. The view of the Bank of England and the ECB that a ‘qualifying securitisation’ should be defined as a security where risks and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a ‘qualifying securitisation’ not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

Relevant Sections/Paragraphs: Paragraphs 100-102 and Box 3

There is a natural counterpoint between, on the one hand, the inherent uncertainty, idiosyncratic risk and unpredictability of all credit products, and the concept of risks and pay offs being “consistent and predictably understood”. It is not clear to us that any credit product could pass the test of meeting such requirements, unless these are to be interpreted so weakly as to cover all or almost all transactions.

We would suggest that a better definition might include that the risks incurred in the transaction are clearly delimited and could be reasonably expected to be understood by a diligent investor, and that there is a clear and consistent way to understand how the performance of the underlying assets can be expected to impact investors.

6. Do respondents think that a liquid market for ‘qualifying’ securitisations used for funding would result from a ‘qualifying certification’?

Relevant Sections/Paragraphs: Paragraph 103

We consider that the mere application of a ‘qualifying certification’ is unlikely to have a material impact on market liquidity. As previously mentioned, the presence or absence of secondary market liquidity is (at least) partially determined by regulatory considerations, and also by the revenue opportunity (for the broker-dealers) of the business. Neither of these points will be directly altered by a ‘qualifying certification’, and so, unless the ‘qualifying certification’ can be convincingly presented as having certain and material economic consequences (e.g. in terms of regulatory treatment) it is unlikely that it would have a material positive impact.

7. These principles may then provide a framework to aid various authorities and market participations to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a ‘qualifying securitisation’? What are the associated risks?

Relevant Sections/Paragraphs: Paragraph 104

Notwithstanding the aforementioned doubts regarding the benefits which might arise from a ‘qualifying certification’, we consider that a framework for such eligibility would have to be clear and unambiguous. One way to construct such a framework would be to address the following aspects of potential transactions:

1. Assets
    a. Eligible asset types (e.g. residential mortgage loans, auto loans etc.)
    b. Eligible asset characteristics (e.g. LTV ratios etc.)
2. Liabilities

    a. Interest rate types (and avoidance of mismatches)
    b. Currency types (and avoidance of mismatches)
    c. Hedging arrangements
3. Structures
    a. Types of cashflow allocation rules (i.e. simple waterfalls)
    b. Exposures to third parties (e.g. liquidity facility providers, derivative counterparties etc.)
4. Legal
    a. Bankruptcy remote
    b. Enforceable security

We consider that it would be challenging for a useful framework to be put in place whereby appropriate authorities would carry out such certifications, because:

i. Investors might be inclined to use such certification as a filter leading to discrimination against all other transaction types, which would lead to only a market consisting only of 'qualifying' transactions
ii. The workload on such a certification agent would be considerable, and would effectively duplicate a large part of the work currently carried out by the rating agencies
iii. The investors might assume that such certification eliminates risk because of the perceived adverse macroeconomic consequences which would result from the failure of a certified transactions, leading to a problem of moral hazard, and potential litigation against a certifying agent for negligence in such circumstances
iv. The standardisation and centralisation of decision making resulting from such a 'qualifying certification' could reduce the diversity of views held within the investor community resulting in increased systemic risk, should it transpire that unforeseen flaws in the 'qualifying certification framework' subsequently emerge.

8. Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?

Relevant Sections/Paragraphs: Paragraphs 105-107

We do not believe that the presence of loan level data is a key issue for the investor community regarding the securitisation markets. In general, our experience is that the investor community is reluctant to engage in a deep-diving analysis of the underlying assets of European securitisation transactions, and hence enhancing the data provision would be of limited value.

The reasons for this (as compared to, for example, the US experience) is likely to be the high level of heterogeneity of the European securitisation asset types (where there are material differences in performance characteristics both with regard to asset types and jurisdictions), and hence the relatively lower reward for developing understanding and analysis compared to the investible assets volumes.

Also, the relative lack of public availability of historical loan-level performance data makes it challenging for investors (other than banks in possession of their own loan-level data) to carry out independent loan-level analysis which might lead to robust conclusions.

9. Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectus and standardised investor reports in a single location be helpful to securitisation markets?

Relevant Sections/Paragraphs: Paragraphs 108-110

We do not consider that the issues surrounding the standardisation of prospectuses, investor reporting or trade transparency are key to enhancing the functionality of the securitisation markets.

When considering such initiatives and further improvements, we are of the view that a balance needs to be stuck between the potential benefits to investors and the potential burden on issuers/sponsors. To the extent that the latter becomes unduly onerous, further developments could potentially hinder the functioning of the securitisation market rather than improve it, even if such developments were to appear beneficial to the investor community.

Given our view on the limited value of such developments at present, we would be cautious when considering such further developments.

10. Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?

Relevant Sections/Paragraphs: Paragraphs 111-115

We are sceptical that investors' access to credit data is of material importance for the re-emergence of securitisation markets. The issue of there being inadequate excess return to justify investors carrying out detailed analysis is not mitigated by provision of more data to be analysed. The provision of such data would only benefit the large incumbent investors with the resources to take advantage of it. The broader investor community, we believe, would prefer to be able to rely on analysis by, for example, the rating agencies, which is already made with reference to such data, and in such a way as to preserve borrowers' commercial confidential interests.

11. In order to aid performance measurement and to provide investors with industry-level data? Would it be helpful if certain macro- economic data were disclosed or if the banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them model credit risk, and how can there be overcome? What other elements would in your view help to improve secondary market functioning for high- quality securitisation?

Relevant Sections/Paragraphs: Paragraphs 111-115

We have doubts that there are either resources or substantial appetite in the investor community to carry out the detailed analysis of loan-level data; hence we regard it as unlikely that the provision of incremental data would materially contribute to a better functioning securitisation market.

12. Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

Relevant Sections/Paragraphs: Paragraph 116

As per our previous responses, we do not consider that such encouragement would be materially beneficial.

13. Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities ratings caps were to be set at high levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

Relevant Sections/Paragraphs: Paragraph 117

Whilst we agree that the provision of this information might be a positive contribution towards the investment process, we doubt that uncertainty about these matters is a significant factor for the market. Hence, while such provision would undoubtedly be helpful and welcome, the impact on liquidity and market functionality is likely to be marginal.

14. How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

15. With regard the policy options mentioned, are there any other considerations authorities should be mindful of?

Relevant Sections/Paragraphs: Paragraphs 118-123

We do not generally regard impediments relating to ancillary facilities as being an important constraint on the market (with one possible exception), and so doubt that substantial benefits would arise from initiatives to address them.

The exception mentioned above relates to derivatives. In the past, the provision of derivatives to enable securitisation transactions to effectively hedge the various interest rate types typically present in asset pools has been important in facilitating efficient transaction execution. The current and evolving regulatory environment regarding derivatives, the typical inability of securitisation transactions to post collateral, and the challenges for institutions in pricing balance-guaranteed swaps (which is the form of Bermudan swaption often required by transactions) at levels which make economic sense for both the transaction and the counterparty, may contribute to forming an impediment to the re-emergence of the market.

16. Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

17. Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in section 2? What might be the associated risks of such options?

18. Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that more amenable to rick assessment? Are there any obvious unintended consequences?

In short, the minimum condition required for the resuscitation of the securitisation market is the development of a broad base of active investors, which in itself would provide the pricing efficiency necessary to encourage issuers. For that to happen the cost and barriers to investment have to be significantly reduced. Amongst the costs to be overcome is the need to perform extensive due diligence on individual issues. This can only be accomplished if due diligence is out-sourced to a limited number of expert parties on whom the market-at-large can rely. The rating agencies are the only entities today that can fulfil that role; regulation via ESMA was an important step to align their incentives with investors. Requiring any additional amount of disclosure in Prospectuses or on-line access to data might be helpful to large institutions that can afford to analyse them, but does little to broaden the market. Requiring institutions to conduct their own extensive asset review is a serious impediment to market development, whilst penalising the investment through higher capital requirements or additional regulatory hurdles than that which is required for investment in corporate or covered bonds, further limits their attractiveness to investors.

Realkreditrådet
ASSOCIATION OF
DANISH MORTGAGE BANKS

To: The Bank of England
The European Central Bank

Copenhagen, 4 July 2014

Answer submitted by:

Realkreditrådet (Association of Danish Mortgage Banks)

COMMENTS ON THE DISCUSSION PAPER ON THE CASE FOR A BETTER FUNCTIONING SECURITIZATION MARKET IN THE EUROPEAN UNION

Dear Sir or Madam,

The Association of Danish Mortgage Banks welcomes the opportunity to comment on the joint discussion paper by the Bank of England and the European Central Bank. Representing Danish mortgage banks that exclusively fund mortgage loans by covered bond funding, we feel compelled to join the discussion by highlighting both the benefits to the real economy and the great performance before, during and after the financial crisis of the Danish covered bond market. Covered bonds deliver a robust and well tested alternative to securitizations that we hope that the Bank of England and the European Central Bank will take into consideration in further discussion of the future of financial markets in Europe.

Covered bonds – a well tested alternative to securitizations

Our response will address the broader questions posed at page 22 of the discussion paper,

Beyond securitization, might there be other ways of achieving (some of) the benefits of securitization as outlined in section 2?

The discussion paper articulates four uses of a well-functioning securitization market:

- An investment instrument for banks and non-banks
- A funding tool to support real economy lending
- A means of generating high quality collateral to meet increased demand
- A risk transfer device for originating banks

Covered bonds as an asset class meet all four uses except bullet 4. Covered bonds embody a standard means of tapping the capital markets for funding backed by good quality assets – primarily mortgages. The fact that the loans securing the covered bonds remain on the balance sheets of the issuer is one of the key differences between securitization

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systems and covered bonds systems – and probably one of the main reasons why the latter performed so much better during the crisis. Accordingly, it is not clear whether credit risk transfer away from the originator is actually a desirable property given the associated incentive problems that became all too apparent during the financial crisis.

In the following, we will shortly present some of the main features of the Danish mortgage model and discuss the merits in relation to the first three bullet points above.

A brief description of the Danish mortgage model

The Danish mortgage model is based on the statutory framework and the way in which mortgage banks operate in practice within this framework. The most important parts of the legal framework are:

- Mortgage banks grant loans secured by mortgages on real property. A limit has been determined for every loan relative to the assessed value of the property financed (LTV limit). Further, the loans are subject to a number of provisions on terms and interest-only periods
- Mortgage banks have only one source of funding: bond sales. A mortgage bank does not operate in the same way as a commercial bank, which may take deposits or raise funding with other banks for lending purposes
- Mortgage banks must observe a so-called balance principle when issuing bonds. The balance principle limits the risk that mortgage banks may incur; credit risk is retained on the balance sheets of Danish mortgage banks whereas all market risk – including liquidity risks and interest rate risks – are outsourced to bond investors such as pension and insurance companies or mutual funds.
- The bonds are bankruptcy-remote. Hence, it is very unlikely that investors should suffer any losses. Throughout the past two centuries, no mortgage bank has been declared bancrupt

Within the legal framework, mortgage banks operate in a way which offers borrowers and investors further advantages. The mortgage system is based on a principle of matching a loan with certain bonds. This means that mortgage banks fund loans by selling bonds with matching characteristics. Therefore, the loan type, repayment profile, term and currency determine which bonds the mortgage bank will sell. Mortgage banks fund loans on a current basis. In other words, the mortgage bank does not sell the required bonds until it disburses the loan to the borrower. The market price of the bonds at the time of sale consequently determines the loan rate. As mortgage banks grant new loans daily, they also issue new bonds daily. This is called tap issuance.

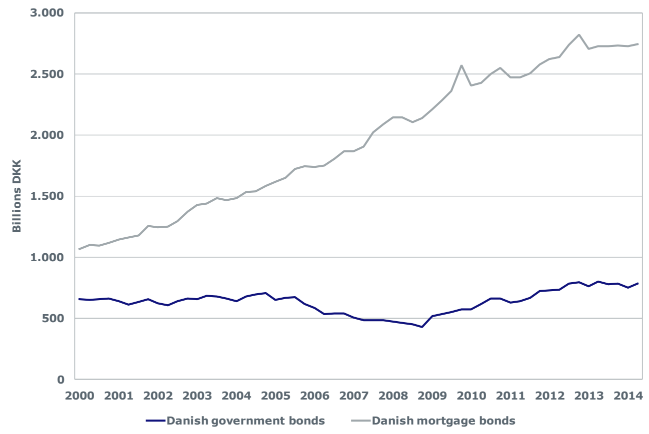
There are several reasons why mortgage banks want to maintain the principle of match funding, even if they are not obliged to do so under Danish law. This is a result of past legislation and mortgage banks' need for reducing the risk of loss prompted by financial market developments. The match funding principle eliminates mortgage banks' loss risk if the market changes during the loan term – for instance if interest rates go up. This is due to the fact that the payments received by a mortgage bank from its borrowers correspond exactly to the payments it makes to the bondholders. However, mortgage banks incur a risk relative to their borrowers, as they suffer a loss if a borrower fails to make interest and principal payments. On the other hand, this strongly encourages mortgage banks to provide good and sound advice to borrowers to reduce this risk to a minimum.

Covered bonds – an investment instrument for banks and non-banks

The Danish mortgage covered bond (henceforth covered bond) market is very large even by international standards. By April 2014 the market value of the outstanding mortgage covered bonds total DKK 2,744bn (EUR 360bn) or 145 percent of the Denmark's gross domestic product – and the mortgage bond market is roughly four times larger than the Danish government bond market (see chart 1). Danish mortgage bonds are repo-eligible with the Danish Central Bank and most covered bond programs enjoy AAA ratings.

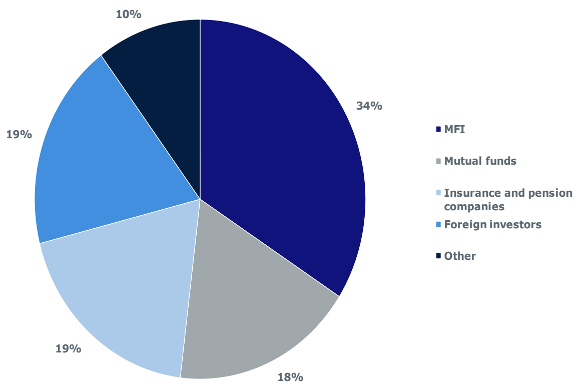
The high level of security has generated broad interest in Danish covered bonds – among Danish as well as foreign investors. The majority of bonds are owned by commercial and mortgage banks, investment funds and insurance and pension companies, which combined account for 70 percent of the bonds (chart 2). Given the nature of their liabilities, life insurance and pension companies have been the main investor segment in the long-term mortgage bonds with fixed coupon. Commercial banks, on the other hand, often invest in covered bonds with shorter maturities as the characteristics of these bonds fit nicely into the liquidity management of banks. Foreign investors account for roughly 20 percent the total outstanding.

Chart 1 – Outstanding Danish bonds



Source: Statistics Denmark

Chart 2 – Danish mortgage bonds investor distribution



Covered bonds – a funding instrument to support real economy lending

Danish mortgage banks have increased their market share throughout the crisis. At a time when traditional commercial banks stopped lending and balance sheets were shrinking, the Danish mortgage banks served as a back stop for the Danish economy and continued lending (chart 3). Covered bonds as a funding tool have thus proven an important alternative to regular bank funding.

Unlike most financial institution throughout the world, Danish mortgage banks did not require government guarantees to issue mortgage bonds during the worst days of financial crisis (chart 4). Consequently, Danish homeowners and businesses did not experience any limitations attributable to the financial market turmoil.

Chart 3 – Annual growth in mortgage bank lending and traditional bank lending in Denmark

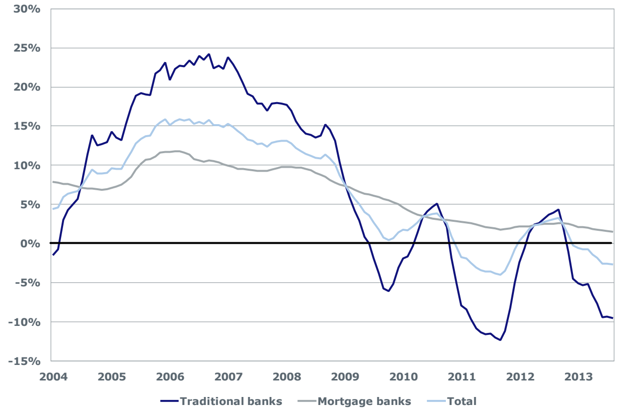
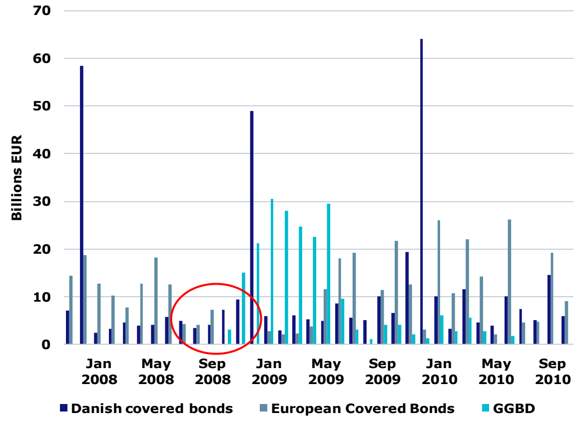


Chart 4 – Issuance of covered bonds and government guaranteed bank debt



Source: Statistics Denmark and Bloomberg

In paragraph 39 on page 7, the discussion paper claims that one of the reason why securitizations might be a useful funding tool compared to covered bonds is that

"Other forms of secured funding such as covered bonds may require higher degrees of over-collateralization and lead to significant asset encumbrance"

This need not be true. Danish mortgage banks are specialized banks that exclusively fund mortgage loans by issuance of covered bonds – mortgage banks are by law not allowed to receive deposits. Accordingly, asset encumbrance is basically not an issue – the degree of encumbrance is 100 percent – and there are no simple depositors that need protection from structural subordination. Further, the degree of required over-collateralization (OC) very much depends on the underlying credit quality. OC allocated to the cover pool behind an issuance of covered bonds typically serves the objective of achieving a certain rating from rating agencies. The specific function of the OC is to close the gap between the cover pool quality necessary for the desired rating – e.g. AAA – and the quality of the loan portfolio in the cover pool, i.e. without the OC. Hence, a high OC will normally occur where a cover pool is otherwise weak and vice versa. In addition, high OC can reflect asset-liability mismatches. The pass-through structure of the Danish mortgage model where all risks but credit risks are outsourced to investors, asset-liability is virtually eliminated. The combination of high quality assets and very limited market risks thus explain the low OC requirements – of less than five percent in some cover pools – for Danish covered bonds.

Covered bonds – A means of generating high quality collateral to meet increased demand

The issuance of covered bonds by Danish mortgage banks transforms illiquid loans into liquid assets. This is of particular importance in a country with limited sovereign debt (42 percent of GDP) and one of the largest pension sectors in the world.

Covered bonds as an asset class have proven equally liquid as most sovereigns before, during and after the crisis, cf. the report on the definition of high quality and liquid assets by the European Banking Authority from December 2013. Covered bonds thus effectively transform illiquid mortgage loans into liquid assets thus supplying the financial markets with high-quality collateral. In the writing of this consultation response, the end definition of the Liquidity Coverage Ratio is still on the table but the general expectation is that covered bonds fulfilling certain criteria will be included in the finest category of liquidity (level 1).

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Thank you for soliciting our comments as part of your Consultation. We remain at your disposal for any questions or requests for additional information regarding any of the comments set out in our response.

Best regards,

Realkreditrådet

Jan Knøsgaard

Deputy Director General

Annex

Structure of Danish covered bonds

The tradition of financing residential and other property through specialised mortgage banks issuing mortgage covered bonds goes back more than 200 years in Denmark. Danish covered bonds may be issued either by mortgage banks (specialised banks offering loans funded by covered bonds) or through segregated cover pools on the balance sheets of banks.

With a volume of EUR 360bn outstanding mortgage covered bonds, the Danish mortgage covered bond market is the second largest mortgage covered bond market in Europe. Danish mortgage banks are subject to special legislation and represent about 95% of the total Danish covered bond market. The following description[1] therefore focus on the covered bond issuance of Danish mortgage banks.

Current Danish mortgage legislation aims to ensure that issued covered bonds are highly secure. To this end, the legislation prescribes continuous LTV (loan-to-value) compliance, with an 80% LTV limit for private residential housing and a 60% LTV limit for commercial properties. Further, the issuance of covered bonds in Denmark is subject to the balance principle. The balance principle ensures that an issuer assumes no significant risks, such as interest rate risk, liquidity risk or currency risk, other than credit risk in respect of its customers. Finally, issuance is subject to a match funding principle, according to which the payments on covered bonds sold fully match the interest payments received from borrowers.

The issued loans remain on the balance sheets of the mortgage banks until maturity, and the greatest risk assumed by a mortgage bank is credit risk in respect of borrowers. Mortgage banks issue covered bonds out of capital centres (cover pools). The cover pools are on the balance sheets of the mortgage banks and consequently subject to financial legislation and control. Banks issue covered bonds out of registers that are very similar to capital centres and subject to very similar legislative treatment.

Mortgage banks obtain funding by issuing bonds registered in a central securities depository. The assets of a cover pool include the issued loans as well as highly secure securities, and the liabilities include the issued securities and equity.

The Danish mortgage system has operated smoothly for 200 years, and no issuer has ever gone bankrupt. Loan losses have amounted to less than 1% of lending – even during the Great Depression in the 1930s. During the recent financial crisis, yearly losses including commercial properties amounted to about 0.2% of total lending.

[1] For more information cf Realkreditrådet/Association of Danish Mortgage Banks “The traditional Danish Mortgage model” http://www.realkreditraadet.dk/Default.aspx?ID=1311

Throughout the financial crisis, Danish covered bonds were traded in larger volumes than sovereign debt, and Danish mortgage banks remained able to fund loans by issuing covered bonds without any need for government purchases or government guarantees of the bonds.

Key points on regulation and security

Mortgage banks are subject to supervision by the Danish Financial Supervisory Authority (FSA), and they must have a licence to carry on mortgage lending. To obtain such licence, mortgage banks must comply with a wide range of requirements based on the CRD requirements applying to credit institutions.

Balance sheets of Danish mortgage banks are structured with a number of separate capital centres (cover pools) out of which covered bonds are issued. A capital centre consists of a group of series in which covered bonds backed by an equivalent amount of mortgage loans (match funding) are issued and a joint series reserve fund (equity). In addition, supplementary capital (senior secured debt/junior covered bonds) may be issued out of the capital centre for overcollateralization purposes.

Loans issued out of a capital centre are secured by mortgage on real property. In addition to this security, borrowers are fully and personally liable for the loans, and loan commitments are up to 30 years. As a result, any credit loss will be covered by the borrowers over time. This calls for orderly and prolonged resolution of an insolvent mortgage bank in order to protect covered bond investors.

Most mortgage banks have several capital centres on their balance sheets. The capital adequacy requirement laid down in Danish legislation must be complied with by the mortgage bank as a whole, but also by the individual capital centre. If a capital centre ceases to meet the statutory capital adequacy requirement, the mortgage bank must provide supplementary capital to the capital centre in order to restore compliance unless such provision would cause the mortgage bank to become non-compliant in terms of capital adequacy.

If a mortgage bank is declared bankrupt, a trustee in bankruptcy is appointed. The trustee looks after the interests of the estate in bankruptcy, i.e. the interests of the creditors and particularly the covered bond investors in relation to the individual capital centres. The trustee must seek the most efficient administration of the estate, having regard to the fact that the position of covered bond investors and borrowers must remain essentially as if the capital centre had still been a going concern. If a mortgage bank is declared bankrupt, no acceleration therefore takes place in respect of covered bond investors or borrowers. The investors risk is in case of bankruptcy on the portfolio of borrowers in the particular capital centre, which is inherently a well diversified portfolio in itself. This is the key principle. It is only possible because the mortgage system is structured around capital centres that offer very high statutory collateral for bonds based on ring-fenced, bankruptcy-remote capital centres and match-funded lending. This characteristic also reduces the wrong way risk that could occur when issuers post their own bonds or when Danish investors post Danish covered bonds as collateral.

Resolution is not fast, but orderly, with a minimum of changes for both bond investors and borrowers. No public funds are used for such resolution, as borrowers' ongoing payments are passed through to bondholders. Holders of hybrid core capital and subordinate loan capital cannot use the bankruptcy of a mortgage bank as grounds for a claim of default. Similar rules apply to counterparties to financial instruments used to hedge risk in a capital centre.

The Danish system ensures a very high degree of security for both bond investors and borrowers, as their position will be affected not by the bankruptcy of a mortgage bank but only by ordinary market changes

The market for Danish covered bonds

The Danish covered bond market is very sophisticated with several product types ranging from short term (1 to 10Y) non-callable fixed rate bullets to long term (10Y to 30Y) callable fixed rate annuities. More than 90% is DKK-denominated and the rest is primarily EUR-denominated. The investor base consists primarily of large professional investors (financial institutions or life and pension funds) – typically 15% is held by foreign investors. Danish covered bonds are the preferred liquidity instrument of Danish credit institutions which typically holds 50% of the issued covered bonds.

Danish covered bonds are typically registered in Copenhagen (VP SECURITIES) or in Luxembourg (EUR-denominated registered at VP LUX) and listed at NASDAQ OMX Copenhagen. All registered bonds are repo-eligible in the Danish central bank and bonds registered in Luxembourg are also repo-eligible in the euro money system. The 100 largest bonds series (ISINs) amount to approximately 2/3 of the total outstanding volume of Danish covered bonds and are traded frequently. All transactions (including OTC) are reported to NASDAQ OMX Copenhagen and published immediately making the market very transparent[2].

The specialised mortgage banks are contributing to the trading activity themselves selling daily tap-issuances or making buy-backs aligned with the mortgage (re-mortgage) lending or refinancing activity. In the past 5-7 years average daily turnover has varied around EUR 2-3bn with spikes up to EUR 13bn in months with refinancing activities. Thus especially the high volume bond series are very liquid.

[2] For a more comprehensive description of the Danish covered bond market, please refer to http://www.nykredit.com/investorcom/ressourcer/dokumenter/pdf/Danish_covered_bond_web.pdf. Nykredit Realkredit is the largest Danish covered bonds issuer.

Danish mortgage lending and refinancing activity, and average daily turnover of the Danish covered bonds continued largely unaffected even during worst days of the financial crises in 2008. Spreads to government bonds increased but unlike most other European covered bond markets trading did never halt and issuers and investors kept being active in the market throughout the days and months after the Lehmann collapse unlike most other financial markets in the world. Observed traded bid-ask spreads widened during the peak of the crises in 2008, but not to a larger extend than traded bid-ask spreads on Danish government bonds. This has been documented by studies made by the Danish central bank while the European Banking Authority has made a similar conclusion in its report on the definition of HQLA.[3,4,5]

Finally, Danish covered bonds are highly likely to qualify as transferable assets of extremely high liquidity and credit quality (level 1 assets) in the EU implementation of the Basel III liquidity framework (Liquidity Covered Ratio).

[3] Buchholst, B.V, J. Gyntelberg and T. Sangill (2010): "*Liquidity of Danish Government and Covered Bonds – Before, During and After the Financial Crisis – Preliminary Findings*", Danmarks Nationalbank Working Paper Series, no. 70 (2010). http://www.nationalbanken.dk/DNUK/Publications.nsf/8b8fe2a60c3a10cbc1256be50057a78e/7a25ccdafbfe3012c12577ae004f4584!OpenDocument

[4] Dick-Nielsen, J., J. Gyntelberg and T. Sangill (2012): "*Liquidity of Danish Government versus Covered Bonds Markets*", Danmarks Nationalbank Working Paper Series, no. 83 (2012). http://www.nationalbanken.dk/DNDK/Publikationer.nsf/side/WP_832012_Liquidity_in_Government_versus_Covered_Bond_Markets!OpenDocument

[5] European BAnking Authority (2013) Report on definition of HQLA. https://www.eba.europa.eu/-/eba-publishes-reports-on-liquidity

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Dear Sir/Madam,

This letter is submitted on behalf of the Australian Securitisation Forum (AuSF) in response to the Discussion Paper titled "The case for a better functioning securitisation market in the European Union" dated May 2014 (the Discussion Paper), released jointly by the Bank of England (BOE) and the European Central Bank (ECB). The Discussion Paper invited feedback from interested parties on the suggested policy options to alleviate the impediments identified in the paper to a robust securitisation market. The AuSF is pleased to accept the invitation to provide comment.

The AuSF was formed in 1989 to promote the development of securitisation in Australia. It is the industry body representing participants in the Australian securitisation market. The AuSF's 91 members act as issuers, underwriters, investors, servicers and professional advisors working on securitisation transactions issued in both the Australian domestic market and global markets.

The AuSF considers securitisation markets to be global in nature and the comments expressed in this letter have been framed in the context of our view of the importance of a robust, functioning and open securitisation market in the European Union to the health of the global securitisation market.

The AuSF commends the BOE and the ECB for taking a comprehensive and fresh look at the issues bedeviling securitisation within the European Union and elsewhere. The AuSF fully supports any appropriate regulatory and market reform that is designed to improve investor protection and to promote more efficient residential mortgage and asset-backed securities (ABS) markets. To that end, although we agree that changes are needed, the AuSF is suggesting that both the BOE and ECB be mindful of the implications of policies adopted in the European Union to the functioning and prospects of the global securitisation market. We suggest that the principles of harmonisation and equivalency of global regulations should guide any policy changes adopted as a result of the Discussion Paper.

Please do not hesitate to contact me should you wish to discuss our comments in greater detail.

Yours sincerely,

Chris Dalton

Chris Dalton

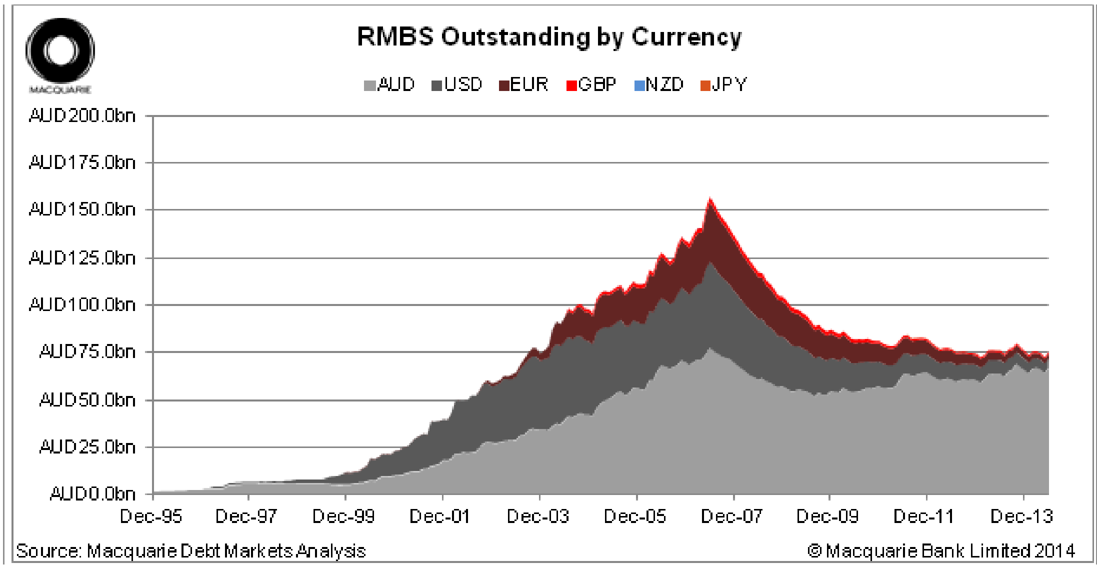
AuSF Comments on the Discussion Paper

References in the following relate to the paragraph numbers in the Discussion Paper.

50. The AuSF supports a prudential approach to securitisation that explicitly recognises that securitisation can be undertaken for either funding or regulatory capital relief purposes. It is true that all tranches in a securitisation contain some degree of credit risk and that the senior notes will have lower credit risk, and therefore can be expected to be more liquid in normal markets, relative to the junior tranches. In our view it is important that the markets for both senior and junior classes of ABS be open, robust and functioning in order to allow securitisation to work as intended. It is important that policy be framed to recognise that different investors have different risk appetites and different return hurdles. Policy should not dictate that only “risk free” tranches of securitisation be sold to investors.

52. We point out that securitisation has been an important market not just in Europe and the United States but it has been an active and vital part of other regional markets such as Australia. The Australian market continued to function through the financial crisis with both RMBS and ABS securities issued to domestic and global investors. Chart 1 below indicates the outstanding value of the Australian RMBS market (the largest sector of the Australian ABS market). The chart highlights the decline in new issuance volumes after the financial crisis and the diminished value of outstanding non-Australian dollar securities.

Chart 1: Outstanding Value of Australian RMBS



63. Through initiatives of both the AuSF and more recently the Reserve Bank of Australia, the Australian market has followed the direction of both the United States and Europe to introduce improved and more detailed data reporting for ABS. The Australian data standards reflect common items with other global requirements. The AuSF believes that policy should reflect the equivalency of ABS data disclosure standards and not seek to impose region specific requirements where an issuer has met an equivalent standard in its home jurisdiction. We agree that harmonisation of global regulatory standards, and the certainty it brings, is beneficial to the market. Importantly harmonisation can also be achieved by mutual recognition of equivalent standards in other jurisdictions.

68. The AuSF suggests that regulatory distortions that create investor preference for covered bonds vis-à-vis RMBS should be removed. Investors should be able to consider both forms of securities without the bias of a more favourable regulatory regime influencing the investment decision. The AuSF has worked with Australian issuers of RMBS and covered bonds to improve the commonality and detail of periodic reports provided to investors.

73. The Discussion Papers notes that increased capital requirements for the trading book assets held by banks adversely affect the economics of market making in securitisation markets. The AuSF considers this to be an important observation and believes the increased capital charges have diminished the liquidity of the secondary market with banks more likely to play a broking rather than market making role in securitisation markets. The AuSF recommends reconsideration of the capital treatment of assets held in trading books to improve the liquidity in secondary markets.

74. Australian issuers of ABS have also sought to sell their securitisations to both domestic and global investors. Prior to the financial crisis approximately 50% of new primary issues of ABS were sold to non-Australian investors. The inconsistent implementation of the risk retention requirements noted in this paragraph is of importance to the Australian market as it seeks to re-establish the global investor base. The AuSF has long argued that regulators should treat as equivalent, the risk retention requirements established in other jurisdictions. As noted above, harmonisation of global regulatory standards can be achieved by mutual

recognition of equivalent standards in other jurisdictions. The current variety of rules relating to risk retention requirements creates inefficiencies in the operation of global securitisation markets.

91. The availability and cost of swaps are an important matter for the Australian securitisation market. Australian securitisation transactions typically use interest rate swaps to transform the cash flows of the underlying assets but also use cross-currency swaps where foreign currency tranches are incorporated into the transaction structure. The availability and cost of swaps have been negatively impacted by the additional regulatory capital required to be held by counterparties and also because of the collateralisation requirements imposed by the methodologies used by credit rating agencies.

92. The Discussion Paper notes the negative impact on the cost of funding via securitisation compared to alternate funding options in Europe (the UK's Funding for Lending Scheme and the ECB's Long Term Refinancing Operations). The AuSF also suggests that the restriction imposed by the ECB under its repo eligibility criteria is another distorting feature of current European policy. In 2009 the ECB changed its repo eligibility criteria to exclude ABS backed by non-European collateral. This impacts the attractiveness of Australian ABS to European investors and hence increases the funding costs for Australian issuers who seek to sell ABS to European investors. The AuSF notes Australia's central bank, the Reserve Bank of Australia, allows Australian dollar denominated ABS to be repo eligible even if the collateral is non-Australian. The AUSF argues there should be greater consistency in the treatment of ABS by central banks to improve liquidity in global securitisation markets.

93. / 94. Illiquidity in secondary ABS markets is a feature considered by Australian investors when investing in ABS. The AuSF is of the view that improved market liquidity, both primary and secondary, is a requirement of a robust and functioning securitisation market. Not only is this important in a domestic market context but improved liquidity in global markets will encourage more real money and long term investors to increase their investment in ABS.

96. The AuSF supports policy measures that seek to expand the investor base in ABS beyond financial institutions. Australia, like many developed economics, has an ageing population and it is important that pension (superannuation) funds and asset management firms see ABS as an attractive and liquid asset class in which to invest to back income style products offered to retirees. The Australian securitisation model has had a strong alignment of interest between issuers and investors and one that is likely to be strengthened by proposed risk retention requirements by the Australian Prudential Regulation Authority[1].

Box 3 Principles of a "qualifying securitisation" – The AuSF understands the attractiveness of prescribing what a "high quality, qualifying securitisation" is but it is vital that any such exercise is global in scope and global in implementation, otherwise it could create a fragmented market with all that means for transparency, comparability, pricing, liquidity and macro-prudential oversight. The AuSF recommends that such labels should not be Euro-centric but be capable of being met regardless of the issuer or asset pool jurisdiction. A suggestion is that each jurisdiction could define what constitutes a "qualifying securitisation" according to some globally agreed principles coordinated by IOSCO. Each jurisdiction could recognise the equivalency of various "qualifying securitisations" to allow securities to be "pass ported" in global securitisation markets. The AuSF submits that it is also important that the cost overheads of such labelling are reasonable and do not add to the plethora of costs recently imposed on the securitisation market.

[1] APRA Discussion Paper "Simplifying the prudential approach to securitisation" 29 April 2014

Comments on the Questions Posed in Section 5 (Paragraph 147).

The numbering below corresponds to the bullet points in paragraph 147 of the Discussion Paper.

1. The AuSF agrees with the benefits of a well-functioning securitisation market as expressed in Section 2. In particular, securitisation provides a source of diversified secured funding for banks and provides capital market investors with a wider array of fixed income securities that have varying yield and risk characteristics to match their investment objectives and risk appetite.

2. The AuSF believes a more coordinated and consistent approach should be adopted by regulators to securitisation exposures to avoid arbitrary differences in the level of regulatory capital required to be held against the same credit risk. A larger and more global pool of investors in ABS will assist the level of liquidity in the ABS asset class.

3. The AuSF considers the availability and regulatory treatment of warehouse facilities, particularly for non-banks, to be important for a functioning securitisation market. It is our view that regulatory treatment of a warehouse facility should follow substance over form such that the treatment of a warehouse facility should follow that of a private securitisation (i.e. a single investor). The mere fact that a transaction is labelled a "warehouse" should not drive its capital treatment.

4. Market liquidity both in the primary and secondary market is a major determinant of a functioning securitisation market. Global regulators should be mindful to not introduce regional regulations that impede the operation of cross-border securitisation markets. A regional market such as Australia is very dependent on access to international investors in Europe, the United States and Asia.

5. The AuSF is not convinced of the benefit of regulators adopting a prescriptive definition of a "qualifying securitisation". Securitisation markets are wholesale markets and investors should be sufficiently expert to determine the nature and complexity of a particular ABS. Importantly we believe a definition of "qualifying securitisation" should not be Euro or region centric but should be principle based and one that could apply to ABS from any jurisdiction.

6. The AuSF submits that the key regulatory requirement for a funding-only securitisation transaction should be that the issuer holds the appropriate level of risk rated capital against the pool of assets. This will align the interests of the issuer and investor. The AuSF is not convinced that a new label in and of itself will create a more liquid market.

7. The AuSF believes that the repo eligibility criteria of ABS adopted by central banks will set the parameters of a qualifying securitisation. It can be expected that such eligibility criteria is likely to change from time to time based on market circumstances and policy objectives. It is our view that allowing central banks to determine what ABS will be repo eligible from time to time will provide a more flexible framework rather than a new and additional "qualifying securitisation" label. The risk of such a label is to stymie the evolution of new types of ABS including SME ABS.

8. The AuSF believes it is difficult to utilise conversion software to compare data reported under various regulator defined ABS reporting templates on asset pools from varying jurisdictions. While there are some common elements to mortgage and consumer finance markets there are also important differences which investors should understand through their own due diligence and a simple conversion tool may be too simplistic to be of value.

9. The standardisation of prospectuses and investor reports is a laudable goal but the objective should be to develop a template that has a common base which can be used for various ABS in multiple jurisdictions without being prescriptively based just on the European jurisdiction.

10. The AuSF believes information from credit registers can provide another piece of useful data to assist in the analysis investors should undertake on securitisation transactions. We note that the availability and use of consumer credit scores in US sub-prime RMBS transactions prior to the crisis did not alleviate poor performance or the losses incurred by investors in those securities. The AuSF does not see access to credit registers as being a precursor to better functioning securitisation markets.

11. The AuSF believes it is unnecessary for banks/non-banks to provide macro-economic and industry-level data to investors. We believe investors have adequate access to such information and banks/non-banks may not wish to hold themselves out as "experts" on such macro-economic data. The AuSF believes that the modelling of credit risk is more pertinent for investors in the mezzanine and junior tranches as typically investors in the senior notes of ABS are insulated against risk (other than in the circumstances of a depression). The AuSF notes the increased coverage of ABS markets by services such as Bloomberg, Intex and ABSNet which provide investors with access to cash flow modelling tools and analytics.

12. The AuSF believes indices play an important role in fixed income markets including when used as a benchmark for investment mandates. Specialist ABS indices may be useful to contrast the performance of a particular transaction to the market average but protections need to be considered to avoid the impact of leveraged investors and hedge funds being able to short the index to the detriment to the long only positions of buy and hold type investors. The inclusion of ABS in broader and market leading fixed income indices is likely to encourage more investors and fund managers to participate in ABS markets.

13. The AuSF has no comment on the issue of the methodology used by credit rating agencies to rate ABS subject to the sovereign rating ceiling of a jurisdiction. We agree that investors will typically make independent decisions to invest in a particular market or not and then consider in which issuer and transaction to invest.

14. The AuSF believes that the availability and cost of ancillary facilities such as interest rate and currency swaps is critical for a functioning market. Since 2008 the cost and availability of such facilities have been constrained by changes in business strategies by various financial institutions, increased regulatory capital charges for such facilities and the collateralisation requirements of credit rating agencies. Also securitisation may be impacted by the reforms of OTC derivative markets which may require securitisation SPVs, which in Australia's case are special purpose trusts, to report swap positions to regional trade reporting repositories. The latter may increase the cost and operational risk involved in securitisation.

15. The AuSF advocates that the BOE and ECB be mindful policies adopted in the European Union do not negatively impact the functioning and operation of global securitisation markets. The AuSF sees access by Australian issuers to the European market to be vital and the opportunity for European investors to participate in the Australian securitisation market will provide European investors with diversification and yield opportunities not available just within the European Union.

16. The AuSF believes a consistent approach by central banks to the repo eligibility of ABS (not just those securities backed by collateral from the local jurisdiction) would be an important component to a functioning global securitisation market. Specifically we recommend the BOE and ECB accept ABS backed by Australian collateral as repo eligible.

17. Securitisation is an established and well-known form of secured asset-backed financing for banks and non-banks. The AuSF believes the recovery, and support, of functioning global securitisations is an appropriate policy to adopt to support the flow of credit in various economies.

18. It is our opinion that the principles for a "qualifying securitisation" as set out in Box 3 need careful consideration to avoid creating new and unnecessary divisions in global securitisation markets. For example, the proposal in paragraph 128 that interest rates should be based on commonly encountered market interest rates could disqualify the majority of Australian residential mortgages where the interest rate is a rate administered by the lender and not specifically referenced to any market rate. It is our understanding that such administered rates are also common in the UK mortgage market. The AuSF believes that the attempt to set out a definition of a "qualifying securitisation" could have unforeseen and disruptive impacts on global securitisation markets.

The case for a better functioning securitisation market in the European Union.

Feedback provided by Banco Caminos, Spain

Do respondents agree with the benefits of a well functioning securitisation market as outlined in Section 2?

We totally agree with the benefits of a well functioning securitization market as a way for funding the real economy as well as a funding tool.

In addition would like to mention an additional benefit for the investor community that is unique and inherent to the ABS product (maybe together with Danish Covered Bonds): the absence of refinancing risk. During 2009-2011 many assets (including covered bonds) were penalized by raters due to refinancing risk, as market was closed for instruments other than government guaranteed bonds.

With this instrument an investor is safe in case of market disruptions.

Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?

We see additional impediments on the CRD IV art. 122a development that might prevent (new) investors to enter in the securitisation market:

- Due diligence requirements (including both the pool and the structure) might be expensive for some small entities and on top of that, this is not required to other comparable assets (ring-fenced pools in Covered Bonds for example).
- Retention requirement, at the end of the day, is a problem for the investor, who must make sure the issuer is retaining interest in the deal, while, for the issuer, selling their retained interest piece , is a risk-free (but reputational) deal.

- The need for systems / models, may lead to excesive reliance in data providers, the same way in the past investors were blamed for excessive reliance in Credit ratings. Furthermore, a mistake in one of the models of this “data providers” can be spread around the community. Some years ago, a famous investment bank had a dedicated team in order to find errors in one of this data providers, as soon as they were finding it, were taking a trading position and then calling the data –model- provider in order to fix it and make short term profits.
- This need for due diligence, models, audits etc... requires specialized staff that might be expensive to pay, and therefore could prevent new investors to enter in the securitisation market.
- This above mentioned due diligence requirements would rather make the issuance of ABS more expensive, as investors will demand higher spreads to cover this expenses.

Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?

Yes, the main concern might be the country rating ceiling, but this could be bypassed just if raters are disclosing rating with and without country ceiling, and making it publicly available at Bloomberg <DES> screen.

In addition Central Banks should carefully think in applying risk weight / haircut to the pure asset rating –without country ceiling-

Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

Personally do not agree, in the sense is expressed in the paper. Pre 2007 we had low trading volumes in ABS market (as all the investors were buy-and-hold) and no one could say it wasn’t a well functioning market, as all market participants were willing to buy paper.

Rather prefer to define liquidity as reduced bid/offer spreads, and in this sense I agree that big bid/offer spreads can be a barrier.

The view of the Bank of England and the ECB is that a ‘qualifying securitisation’ should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a ‘qualifying securitisation’ not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

Completely agree. In addition would like to highlight the need for:

- Standardised reporting template for deals containing similar assets and located in the same country. The servicer/fund manager needs to issue it at least on a quarterly basis, and no later than 5 business days after the payment date.
- Stratification tables should be made available not only at the issue date but also on a quarterly/monthly basis.
- Furthermore, the reports should be made available in a user-friendly way so the investor can copy/paste easily from it (no pdf please).
- Triggers level should also be reported clearly so the investor is knowing at all time how close or far is from trigger level.

Do respondents think that a liquid market for ‘qualifying’ securitisations used for funding would result from a ‘qualifying certification’?

Not sure if just the label would work. During the crisis the most liquid ABS assets were the UK master trusts and Dutch RMBS with “no label at all”.

All of these were sharing one characteristic: have a specific call date, that makes easy to predict the WAL, and makes the deal less sensitive to prepayment speeds. This is one of the most important data to be calculated, and much more when the bond is trading far from par.

What is quite difficult to understand is that even when master trusts demonstrated that calls could be not exercised (Granite non-asset trigger) market is still pricing the deals to the expected call date, while in other jurisdictions (Spain, Portugal) are priced to final (not legal) maturity even if the originator is calling the deals.

These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a ‘qualifying securitisation’? What are the associated risks?

Pendiente

Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?

While it’s clear that harmonisation and access to informations seems to be positive, too much information may lead the ABS to be seen as a quite complex product.

Anycase access to the European Data Warehouse should be made accessible to any market participant, regardless of the nature of the business. EDW fees make a **huge** difference between Institutional Investors and Active Market participants, while, at the end of the day it is not clear where you’re falling if you hold a large investment book but also actively trade ABS in order to maximize the return.

Making these differences create asymmetries between market participants.

Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?

We’re quite concerned on the so-called “post-trade transparency”. We remember the 2007 after summer time when SIVs and conduits were in run-off. These vehicles has a mark-to market trigger that forced many of them to fire-sale many assets when valuation (mark-to-market) was below a certain level. These sales forced other vehicles to also fire-sale their assets and all this ended in a vicious circle than ended both the SIVs/Conduits as well as a well functioning ABS market.

Runs / screens should be enough for any market participant, the same way is for other assets just like the corporate bonds.

Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?

As far as we know there is no (at least in Spain) index such as the FICO. Debt to income is quite difficult to be updated and subject to volatility. A datafield in the loan by loan with information related to CIRBE (Bank of Spain) and updated on a periodical basis should provide enough information.

In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

Just providing average of CIRBE levels strated by regions guess shoud be enough.

Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

Guess those indices are already in place (CIRBE) should only work in making publicly available.

Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

Completely agree. Furthermore, the ratings of a selected security should be presented in the following way BBB(sf)/AAA(sf) (actual rating/rating with no cap)

How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

In principle those are covered by raters downgrade language, but in old deals this downgrade language is in place "*to preserve the bonds ratings*". If the bond rating is capped at the country ceiling, the downgrade language is preventing the Originator to move the account to other suitable entity.

If the Reserve fund is funded at the required level, and the monies are deposited at the Treasuty account outside the Originator, this may act as a disincentive to securitise, as the Originator is losing part of the liquidity is getting through the issuance of the bonds (much more at present days when the raters are asking for huge credit enhancement figures.

The only solution that might be suitable is opening a bank account in the name of the fund at the Central Bank, and that this moneis could be deducted from the "Mandatory Bank Reserve" or similar.

With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?

Since the beginning of the crisis the investors have been blamed for the excessive reliance in credit ratings, while not making their own credit assessment.

But regulators (Central Banks/EIOPA/ CNMV) are acting in the same way:

- Ask for 2 credit ratings to include them in the eligible assets list
- Haircut is directly linked with rating
- Risk Weigh is directly linked with rating
- CNMV is also asking for them.

Central Banks should de-link their policy from credit ratings, or not asking the investors to do it on the one hand, but asking for ratings when they turn around.

Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

To incentivise the use of guarantee schemes around Europe such as the FTPYME and FTVPO programs.

One thing is EXTREMELY interesting and aligns interests between Originators and investors is the artificial write-off mechanism present in most of the Spanish ABS deals. By this mechanism the Fund is amortising the senior bondholders 100% of the outstanding on the defaulted loans – default definition may change from deal to deal but is always 12-18 months- Therefore, the Originator (who is retaining the most subordinated part of the deal as well as the excess spread, will collect little or no monies if underlying loans are defaulting. Furthermore, Originator will be the most interested in recovering a defaulting loan.

Another point would be that after the issuance, the Originator is still servicing the loans. If, for some reason the Originator has to get rid of the servicing loans, also has to transfer the “5% risk retention piece” to the buyer.

Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?

Spain has already legislated a figure called “Bonos Hipotecarios” that is a kind of structured covered bond, that could be used for the same purpose; could also open the scope of assets to SME’s.

Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?

This paper is mainly focused on credit risk while most of real economy transactions have been proved resilient during the crisis. Credit risk in most cases has not been a problem in most cases, or has been proved as easy to handle.

Main problem has been calculating the WAL while the bonds are traded below par, as most part of the profitability of these assets is the difference below price and par the investor is getting in each partial amortisation. If we continue focusing in credit, we won't solve the problem

Final remarks

For sure the risk weight charge when holding these assets is a problem both to banks and insurance co. Furthermore when this ratings are capped at the country ceiling.

Spanish CNMV has discouraged asset managers in investing in this asset during the last years in several ways, as making the fall in the illiquid category.

Spanish CNMV is EXTREMELY slow during the issuance of a deal, and trend to focus in irrelevant Prospectus details and wording.

Need accurate cash-flows provided by the fund manager, with different scenarios, and regulator should make sure these are back-tested on a periodical basis in order to make sure the investor can trust them.

Need standardized investor reports (single template) in order to facilitate the investor to compare amongst deals.

Final comment not specially related to ABS but to CBs: Risk weigh in covered bonds is related to the issuer senior rating regardless of the pool. Therefore, the issuer has no regulatory incentives to preserve credit quality or overcollateralization.

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Dear Sirs,

The case for a better functioning securitisations market in the European Union - Discussion paper

Barclays welcomes the opportunity to comment on the Bank of England and ECB discussion paper on the securitisation market. We are encouraged that there is recognition that a well functioning securitisation market provides many benefits across economies. We have also been encouraged by the open dialogue between the Bank of England and market participants that has preceded the publication of this discussion paper and look forward to contributing further in the process of re-establishing a robust and well-functioning securitisation market.

As a global bank, we are active in many aspects of the securitisation market, including as issuers, investors, advisors and swap provider in European and overseas markets.

Our key messages are detailed in this letter with further detailed comments and answers to the questions asked in Appendix 1.

An international securitisation market requires international co-ordination

We would strongly encourage the Bank of England and ECB to ensure that any initiatives that result from the paper are pursued, as far as possible, in international fora. Without this, there is a risk of further fragmentation of the securitisation market into small regional markets – impacting the overall stability of the markets and limiting the amount of funding securitisation can provide to the "real economy".

The discussion paper is naturally very focused on developments within the EU and does, rightly, distinguish between the performance of many European securitisations during the financial crisis and US subprime mortgage securitisations. However, in order to ensure there is a deep and liquid market in securitisation products and that securitisation is a cost-effective option for issuers - alignment of international requirements is important. An example that is cited in the paper concerns the difference in the current retention requirements between the EU, where the obligation is on the investor to ensure retention has been adhered to and US, where the obligation is on the issuer. In addition, there are differences in loan level disclosure requirements from the authorities in the UK, Europe and USA. The differences between these requirements contribute to increasing the cost and complexity of cross-jurisdictional issuance and make securitisation a less attractive funding option.

DRAFT

Regulatory requirements and regulatory uncertainty are the biggest impediments to the development of the market

In our experience, the largest barriers to the return of a well-functioning securitisation market are inconsistent regulation and regulatory uncertainty. To use BCBS 269 as a general example: first, the capital requirements proposed in BCBS269 result in relatively high levels of capital to be held against highly rated securitisation exposures. In addition, there will be differences between jurisdictions in the implementation of the requirements. For example, as one approach is based on ratings and as such cannot be used in the US, the implication is that for the same exposure, banks in different jurisdictions may carry different capital requirements. Finally, as the paper is still under review – it is not certain what the final capital requirements will be.

Whilst papers such as this one are more positive, much of the regulatory work in the post crisis period has had a detrimental effect on securitisation as an asset class. The overall effect of these factors means that it is not only difficult for banks to assess the total costs of undertaking securitisations but the indications seem to be that it will remain a high cost option.

We would also note that the cumulative effect of the regulatory changes undertaken in response to the crisis – both those aimed directly at securitisation and those which had a broader focus – have eroded a conducive environment for securitisations over time as participants have retracted from this once successful segment of the market. We urge policy makers to take into account these changes and their cumulative impacts when assessing new initiatives in relation to securitisation.

Standardisation of data rather than quantity is important

We welcome initiatives that could facilitate the standardisation of data published for certain securitisations. In our view, care needs to be taken with respect to requirements that result in issuers needing to publish significant quantities of data on each transaction. We agree that the lack of standardisation of data by issuers makes it difficult for investors to assess the risk of any particular securitisation both in its own right and in comparison to other transactions. However we believe that requiring significant levels of detailed disclosure would not only impose additional and in some cases prohibitive costs on the issuers but also create competitive, commercial and customer privacy concerns without necessarily creating an increase in transparency with the concomitant increase in investor confidence that would be needed to support a well-functioning market. Furthermore securitisations of assets that are less homogeneous in nature (e.g. corporate loans) often have variations within documentation disclosure clauses that would require thorough due diligence, and may restrict ability to disclose information. Regulators should look at country specific availability of certain data while ensuring that there is overall consistency in the types of data being disclosed across various jurisdictions.

The overriding consideration is that any disclosure must work for investors, regardless of size. For investors who are required to comply with due diligence requirements, it is likely that only larger, more sophisticated investors are likely to be in a position to meaningfully digest large quantities of data, be that in-house or by purchasing the services of a data service provider, with smaller or new investors potentially discouraged by the volume of disclosure it would be required to analyse both prior to investing and on an on-going basis. In addition, requirements should not act as a barrier to entry for potential new issuers. From an issuer point of view, the infrastructure required for significant levels of different disclosure – for example current issuances may need five different types of loan level disclosure- may act as a deterrent to entry.

"Qualifying" securitisations - care needed not to create a two–tier market or one-tier market

We welcome the proposed concept of "qualifying" securitisation as a means of increasing confidence in the securitisation market. As we note in Appendix 1, how beneficial it is will depend on the exact benefits of "qualifying" status. To be fully effective, the implementation of the concept of "qualifying" securitisations would need to be carefully managed to ensure that a two-tier market consisting of on the one hand highly liquid "qualifying" securitisations and elsewhere a less liquid market of those transactions which do not qualify. At the extreme, a "one-tier" market could be created where the only securitisation transactions would be "qualifying" transactions – we believe this would be a damaging outcome which would reduce the diversity of funding available to firms and products available to investors.

We hope that you find these comments and our response to the questions useful. We would be very happy to discuss these and any related points further. Please do not hesitate to contact Roger Versluys (roger.versluys@barclays.com or +44 20 7773 2791) if you have any questions or comments on the issues raised in this response.

Yours sincerely,

Meen Adams

Barclays Chief Accountant

Appendix 1: Answers to discussion paper questions

1) Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?

We agree with the main benefits set out and broadly agree with the distinction between risk transfer products and liquidity products.

2) Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors and, if so, what are they?

We agree with the impediments identified. We note that, whilst dormancy in the European securitisation has not been solely due to regulatory factors; the overall thrust of regulation has increased the challenges to make securitisation an attractive option for banks, both as originators and investors.

Uncertainty on what the securitisation capital requirements will be, which securitisation instruments will be considered for highly liquid buffers for the purposes of Liquidity Coverage Ratio and the potential penalties for failure of the due diligence requirements, which are in some places subjective, mean that while investors may have appetite for the exposure to securitisations (both from an assets and risk profile perspective) – they will tend to look at other instruments where the costs of asset identification and capital cost of holding is lower and at less risk of adverse change.

For other regulated, non-bank investors – costs of regulation are also increasing. As noted in the discussion paper – work on capital requirements for holdings of securitisation positions under Solvency II adds to the uncertainty on capital costs for insurers.

3) Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents think that there are any additional impediments to issuers, and if so, what are they?

We agree with the impediments identified and would say to a greater extent than for investors, regulatory factors are the main impediments. In general, securitisation represents the highest cost capital markets funding option for banks and this is due mainly to regulatory factors. Banks as issuers have limited incentive to use securitisation unless overall regulatory requirements could reduce the funding costs associated with securitisation or if it facilitates the reduction of the regulatory balance sheet – both from a regulatory capital and a leverage perspective.

In addition, uncertainty as to the final regulatory requirements and how they will be implemented is making banks reluctant to fully re-enter the market. For example, at present the uncertainty with respect to whether significant risk transfer (SRT) could be achieved for securitisation transactions has inhibited firms from investing resource in developing new securitisation transactions, given the difficulty of assessing what returns will be on a transaction. This overall regulatory uncertainty does not only affect risk transfer trades, it also inhibits firms from undertaking funding transactions.

4) Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

We regard market liquidity as a useful ingredient to the good functioning of the market but the more important aspect that needs to be considered are the constituents of that liquidity – i.e. higher and more stable levels of demand for and supply of securitisation products. In this regard, we believe issuers would benefit with more predictability on whether a particular transaction could attain SRT and the associated benefit. In addition, firms acting as market-makers would benefit from more certainty on the capital charges for trading positions and in regulators ensuring that these charges are proportionate to the risk incurred. This would increase the willingness of market makers to deal in such positions, which would be essential to any increase in liquidity.

More importantly than either of these factors is the need for sufficient primary demand from investors. There would also need to be an appropriate mix of long-term and short-term investors. We note that many non-bank investors, such as pension funds, tend to be long-term investors. An increase in investment by these firms would only have a limited impact on market liquidity.

5) The view of the Bank of England and ECB is that a "qualifying securitisation" should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a "qualifying securitisation" not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

At present, the discussion paper does not provide sufficient detail to allow us to respond to this question definitively. The appropriateness of the definition of "qualifying securitisation" will depend on the consequences for firms of undertaking a "qualifying securitisation", e.g. would it be subject to different regulatory requirements, would the assets that resulted from such securitisations be eligible for specific capital treatments or qualify as "high quality and liquid" for LCR purposes? This would then inform the incentives firms have for obtaining qualifying status for securitisations that they originate and for investors to invest in them and the consequent changes in behaviour that occur.

It would also be useful to understand how the authorities would view the development of the market for "non-qualifying" securitisations. In the current securitisation market, there is a continuum of transactions which vary by levels of complexity, quality of underlying assets etc. We regard this as appropriate as in a well-functioning market with appropriate levels of disclosure, there should be a place for both low and high risk transactions to meet investor demand. Do the authorities envisage that this would continue if "qualifying securitisations" were introduced or that there would be broadly two types of securitisation, qualifying and non-qualifying?

The risk of the second approach is the market becomes divided into "good" and "not good" securitisations with some investors assuming the latter securitisations are unsafe to invest in whilst the former may be seen as safe to invest in only on the basis of limited due diligence. This would be of particular concern for transactions which are of the same risk profile as many "qualifying" securitisations but are treated as "non-qualifying" on the basis of one principle (e.g. A synthetic transaction). Of even greater concern is that the possible development of a "one tier" market where the only securitisation issuance is of "qualifying securitisations". This would be an unwelcome outcome that would reduce the diversity and liquidity in the market and would likely stifle innovation.

Notwithstanding the above, we agree with an approach that defines "qualifying securitisations" by its characteristics, both of the underlying assets and its structure. We agree with the high level definition; however it will be crucial that the authorities monitor the impact on the market of "qualifying" and "non-qualifying" securitisations and on the detailed principles of a "qualifying" securitisation. If these are not reviewed and updated as the market develops – the result is likely to be a stagnant and limited securitisation market.

With respect to the principles set out in Box 3, please see our comments in response to question 18.

6) Do respondents think that a liquid market for "qualifying" securitisations used for funding would result from "qualifying certification"?

Absent any accompanying regulatory initiatives, the "qualifying certification" is likely to help certain investors re-gain confidence in the asset class but we believe the change in market liquidity would be limited. We note that in the US, there is relatively higher liquidity for SEC registered platforms as these are required to meet Reg AB requirements, such as enhanced disclosure.

As noted elsewhere, care would need to be taken to ensure that any increase in liquidity is not at the expense of prudent risk management on the part of the holders, i.e. that firms are not increasing their holdings of paper on the assumption that the certification can replace meaningful due diligence.

In addition, care would need to be taken that a more liquid market for "qualifying" securitisations is not at the expense of liquidity for those securitisations that do not have "qualifying" status. In other words, "qualifying" securitisations would only be truly beneficial if they helped to increase total market liquidity.

Finally, the presence of a liquid market will be dependent on the type of investor that holds paper from "qualifying" securitisations. In particular, some non-bank investors tend to be long term "buy and hold" investors. In this case, even if their willingness to buy securitisation paper increased – this would not necessarily increase liquidity.

7) The principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a "qualifying securitisation"? What are the associated risks?

With respect to the development of the framework, as noted in our response to question 5 – it very much depends on what benefits being a "qualifying securitisation" may bring. In general, with respect to the framework – we believe that overall governance of this should rest with the authorities. We believe that this is the most likely way if avoiding the potential moral hazard risks associated with designating certain securitisation as being "safer" than others.

8) Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which assets classes should be targeted? How can accessibility to loan level data be improved, so that it provides the most value to investors?

In general initiatives that limit the amount of times an issuer has to disclose the same information in different formats would be welcome. As noted in the cover letter, for certain transactions at present – we have to disclose loan level data in slightly different formats five times[1]. This represents an unnecessary overhead which whilst not currently prohibitive, could be eliminated relatively easily.

However, standardisation needs to be sensible and proportionate. Mandatory disclosures need to ensure that they are appropriate for each market that the issuer operates in, for example the concept of "credit score" is applied very differently within the USA as compared to Europe, and requirements for disclosure of this would need to be capable of adapting to these differences. In addition – care needs to be taken with loan level disclosure to ensure that it would not breach the confidentiality requirements of the underlying loan agreements.

With respect to investor access to data – we are not aware that lack of access to this data is a material concern at present. We would note that cashflow modelling/valuation providers such as ABSNet, Intex and Bloomberg already provide investors with loan level data meaning the investor does not necessarily need to access this directly from the issuer direct.

The main objective with any disclosure to investors is to make sure it is clear and can be used by all investors. Disclosure that deters new or smaller investors (e.g. if it is of a volume which cannot be meaningfully analysed by any firm without significant infrastructure or means to pay a data provider) would be unwelcome.

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[1] Loan level disclosure templates would need to be completed for three different ECAIs, Bank of England and ECB.

9) Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements?

With respect to standardisation – we believe more could be done by authorities in different jurisdictions to ensure their own requirements are as aligned as far as possible. One way of achieving this would be to create a single template with limited mandatory fields but sufficient optional fields to ensure appropriate disclosure in each jurisdiction. Taking the example of credit scores referred in the response to question 8, this would mean that credit score data would be disclosed on the template where the underlying assets were originated in the USA but not for those originated in jurisdictions where credit scores are not widely used.

The ESMA RTS under CRA 3 which sets out disclosure requirements for issuers of structured finance instruments is generally helpful in setting out common minimum disclosure standards for securitisation. We are also grateful for ESMA clarifying that disclosure would not be required to the extent it clashes with national or European Union law governing data protection and privacy. However, we are concerned about the following requirements:

- Disclosure of loan level data on credit card receivables may result in commercially sensitive data being made widely available.
- The possibility that the loan level data requirements may apply to private transactions. The benefits of such disclosure versus the cost are unclear to us. We understand ESMA may believe it has limited discretion in this area but we would urge that work is progressed to arrive at appropriate requirements.
- The requirement to disclose all transaction documents, including those of a proprietary/sensitive nature such as subscription arrangements or programme dealer arrangements.

Finally, we think the input of the ratings agencies and other market participants is crucial to ensure standardisation can be most effective. As noted earlier, lack of standardisation between ratings agencies currently means that we are required to provide different versions of the same data to different ratings agencies. Standardisation would reduce these costs.

10) Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure borrowers' confidentiality is preserved?

We agree that increased transparency should facilitate investors to make more informed decisions and as such increase market confidence. In achieving this, the authorities and market participants will need to consider several factors:

- *More data does not necessarily mean greater transparency*. In determining what data issuers should provide to the market, consideration needs to be given to the capacity of investors to analyse the data meaningfully. Also there is the risk of other market participants, e.g. research analysts, using the data for purposes other than that which it was intended, e.g. using any loan level data disclosed as indicative of the risk in the firm's balance sheet.
- *Commercial sensitivity* Some proposals for disclosure of loan level data (for example ESMA's RTS on Information on Structured Finance Instruments) is at such a granular level that as an issuer we would be concerned that for certain assets classes, e.g. credit cards, it would allow competitors to reverse engineer the data provided to determine our pricing strategy and risk models. Requirements for this kind of disclosure could result in firms reducing their issuances rather than

risk competitive disadvantage. In addition, any disclosure would need to ensure the confidentiality rights of the borrowers were adhered to.

- *Scope* As we noted above, it would be useful to define whether the scope of any data disclosure would also include private transactions. As private transactions tend to be bespoke in nature; there would be little to be gained from including these in any aggregated data.

We believe that standardisation of data disclosure for certain public transactions would increase transparency for investors; provided the limitations of the data are clearly articulated and understanding.

With respect to credit registers, we regard them as a useful tool once they carry sufficient data. To achieve this we believe would most likely to take decades and so the benefit for jurisdictions that do not yet have credit registers will be in the longer term only.

11) In order to aide performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed of if banks/non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

As with the response to question 10, we believe that greater transparency would be helpful but that this needs to be managed carefully to ensure that there is not excessive disclosure and that there is sufficient clarity to market participants with respect to what the data published represents and how it is intended to be used.

With respect to the key challenges, please see our response to question 10 above.

12) Do respondents think the authorities should consider encouraging benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

As with other questions on data, the usefulness or otherwise of benchmark indices will depend on how they are compiled and how market participants use and view them. If used correctly, for some investors, they may provide a useful proxy for the overall performance of the underlying assets and may address some of the concerns on confidentiality; the risk of course is that the indices become divorced the underlying assets and amplify credit cycles.

13) Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

In relation to this question, we think the broader question of how investors and ratings agencies are using ratings needs to be considered. It could be argued that the issue is not how the ratings are set but where and how they are used in firms' investment decisions. For example, if the issue that certain investors cannot invest in items with a certain rating – the reasons for that need to be better understood before determining whether publishing an effective "shadow rating" is appropriate.

However, to the extent that ratings are used in setting regulatory capital requirements – greater sensitivity to structural factors which affect ratings (such as sovereign caps) would be welcome.

14) How important do respondents see the impediment related to the availability of ancillary facilities?

We regard the impediments to the provision of ancillary facilities as important both in our role as a provider of these facilities, mainly securitisation derivatives, and as a user of these facilities, as an issuer.

With respect to securitisation derivatives, there are several regulatory impediments to the functioning of the market:

- Capital, liquidity and leverage requirements
  - LCR/CLR pool –securitisation swaps contain ratings triggers that would require the swap provider to post mtm plus a significant initial amount in the event of a downgrade. This amount is not required before downgrade. This creates a large CLR requirement for this activity. To meet the LCR/CLR we are required to hold a pool of cash/liquid assets which would cover any outflows in a ratings stress scenario. We believe that these holdings should be carved out of both leverage and regulatory capital requirements, in particular deposits with Central Banks.
  - Regulatory capital requirements for derivatives – the SA-CCR requirements will increase both the complexity of the capital calculations and their cost. One way of mitigating the impact of this would be to set alpha to 1 rather than 1.4. We would regard this as particularly appropriate in the case of leverage calculations which is a risk insensitive measure that does not factor in the likelihood of default; whereas the alpha factor relates to the correlation between the likelihood of default and the exposure value at point of default.
  - Inferred ratings – the current (and proposed) future capital requirements only permit unrated positions to be risk weighted using an inferred rating from a subordinate position. This results in disproportionately high capital requirements for senior swaps or imposes the cost of firms having to obtain ratings. We believe inferring a rating from a pari passu position is more appropriate.
  - BCBS 269 – maturity In the BCBS 269 consultation, the Basel Committee continued to recommend that maturity be based on legal final maturity, as opposed to its weighted average life. The latter would be more reflective of how securitisation exposures are risk managed. One approach here would be for maturity to be based on weighted average life but using supervisor set prepayment rates.
- Clearing Costs – securitisation derivatives cannot be centrally cleared as the related SPVs are unable to post collateral. As a result, these derivatives are not eligible for the preferential risk weights which are available for cleared derivatives. A solution to this would be to permit securitisation derivative hedging counterparties to classify SPVs as NFC (-)[2] under the EMIR classification. In addition, the proposed EBA standard on uncleared derivatives should increase the scope of the treatment of covered bonds to all SPV securitisation structures using the current Agency CSA framework for risk mitigation.
- Impact of Volcker/EMIR regulations - We note that whilst the Volcker rules have provided carve-outs for derivatives related to loan securitisations, the related EMIR is still considering how these products will be treated. This uncertainty means that it is difficult to assess the relative risks and rewards of the provision of securitisation derivatives. In addition, the proposed EMIR requirements relating to the calculation of swap margining requirements are different to those that are in existing CSAs. There is currently no guidance as to how firms will meet both requirements.

We also believe greater standardisation of securitisation swaps documentation, agreed with the ratings agencies, for qualifying securitisations would facilitate the development and deepening of the market for these securitisations.

[2] Non-financially cleared but under the clearing threshold.

14) Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

There would be certainly benefits to exploring whether SPV bank accounts could be placed outside a firm's insolvency estate - however further detailed analysis of the concept would be required amongst industry professionals. The key benefits would be: the amount of account banks available could increase which may drive more competition and related benefits, (e.g. lower fees and/or higher rated for SPV deposits); and member states and their banks would be less sensitive to deposit outflows from a breach of ratings thresholds (originators/sponsors could potentially remain as account banks on their own transactions even in the event of a downgrade of the originator/sponsor). These benefits assume that the rating agencies methodologies would not remain the same and be updated to take account of the new preferential insolvency position of SPV bank accounts. As we note below – the views of the ratings agencies on such a change are crucial.

However, there would be challenges to creating such a framework – not least the need to change national and supra-national law within the EU. It is also not clear where within the work on structural reform this initiative would sit, for example whether there was the potential for securitisation bondholders to have preferential treatment to depositors.

Alternatives to a statutory solution may be achieved via use of existing contract and trust law. However, this would likely be a complex process. In addition, moving an SPV's accounts away from an originating bank would have many practical considerations that come from adding another party to a transaction.

Overall, assessment of whether such an approach would provide sufficient benefit to outweigh the costs would require a wide range of industry input but most crucially from: ratings agencies, lawyers, insolvency practitioners and securitisation specialists.

15) With regard to the policy options mentioned above, are there any other considerations authorities should be mindful of?

As the challenges for issuers and investors in the securitisation market are overwhelmingly regulatory in nature, and in particular related to regulatory capital; the key initiative the authorities could take would be to take a holistic view of the regulation of securitisation. This would involve reviewing the many regulatory requirements, both current and proposed, related to securitisation and actively considering:

- what risks the requirements are mitigating;
- whether some requirements overlap or duplicate each other;
- how effective the requirements have been at mitigating identified risks;
- any unintended consequences of the requirements;
- what actions market participants have taken themselves to mitigate the risks identified and whether this now means that the regulatory requirements are redundant.

This should include consideration of regulations that do not target securitisation directly but do impact on it. Examples of this would include: structural reform, liquidity requirements, the fundamental review of the trading book and Volcker/EMIR requirements.

With respect to the last bullet point above, it is important to note that within a securitisation transaction – ratings agencies will impose requirements, such as structural features, which are designed to meet some of the concerns that the regulators have regarding securitisation. By imposing incremental requirements, such as capital or liquidity charges, firms are effectively required to mitigate the same risk twice with the associated cost.

Our strong preference would be for this review to be undertaken on an international basis. Whilst much can be achieved within the EU; the global nature of the ABS market means that only a co-ordinated international approach would allow it to properly function.

16) Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

One of the key aspects we believe the authorities need to consider is how they would expect the options set out here to evolve. For example, the principles set out in Box 3 rule out any kind of synthetic securitisation from receiving "qualifying" securitisation. In addition, we believe that "qualifying" certification would not be possible for most non-European securitisations for various reasons. In both these cases, this would mean that some transactions of a relatively low risk profile would be treated in a similar fashion to higher risk transactions.

Just as we regard it as disproportionate for securitisations which performed well during the financial crisis to be risk weighted in the same way as those that incurred high losses; it will ultimately be disproportionate to treat all "non-qualifying" transactions in the same way.

We recognise the desire of the authorities to create a framework which is simple and transparent and, because it is yet to be tested, relatively conservative. However, if the framework does not have included in it the ability to evolve, it will start to distort market behaviour not in the way originally intended.

17) Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?

We believe that a robust securitisation market is the best way to achieve the benefits outlined in the paper.

18) Do the principles set out in Box 3 seem broadly sensible given the objectives of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?

With respect to the principles set out in Box 3, we have the following comments and questions:

- **Underlying asset performance history** We would interpret this principle as requiring at least 7 to 8 years of data. During this period, it is likely that firms will have changed their underwriting criteria; we would like to understand if the authorities would view this as meaning the assets were no longer "substantially similar".
- **Expectation of payment** This principle includes demonstrating for non-granular pools that the loans etc could be to obligors with "prudent and consistent" underwriting criteria. For this principle to be effective, further clarity would be needed to be provided on what is meant by "prudent" in this context. For example, would certain asset types (e.g. auto loans) by default be assumed not to have been originated on a prudent basis? Or would it be based on the requirements that already exist in the Capital Requirements Regulations (CRR) that require credit granting to be on the same "sound and well-defined basis" as to all other exposures in their banking book? In addition, it would be useful to understand how it is envisaged that originators could demonstrate compliance with these criteria.
- **Current and self-liquidating** This principle would most likely exclude a significant amount of underlying assets, for example leases. As in most securitisations of leases, for example auto leases, the value against which investors advance is based on the amount lent and the expected residual value of the underlying asset. As the residual value is not "self-liquidating", we would assume these types of securitisations would not be regarded as "qualifying". We are not sure if this is the intention of this principle, given that in paragraph 134 of the discussion paper, auto leases are included in the list of assets that may comply with the principles. We would note that lease transactions fund many "real economy" assets and have typically had a low risk profile.

- **Initial data** We believe that originators would be reluctant to provide cash flow models to investors - as the potential conflict of interest would be likely to raise legal issues. At present the structuring bank normally provides the raw data to another company (for example Intex). This company allows users to create their own stresses and cash flow models. We are concerned that if originators were required to provide these, they would be viewed as providing some form of guarantee of the performance of the securitisation.
- **Ongoing data and information** As noted elsewhere, we think there is merit in the production of standardised information. However, the bespoke nature of many transactions means that the degree of standardisation would need to be considered, i.e. it may be easier for issuers to complete a high level standardised template, including the information relevant to their transaction, than comply with detailed prescriptive mandatory disclosures. We would also question the extent to which investors can make meaningful use of very granular disclosures.
- **Conformance with Prospectus Directive** We do not agree that disclosure should conform to the Prospectus Directive. As noted in our letter, we believe that the approaches set out in the discussion paper will be most effective if pursued internationally. The use of the Prospectus Directive as the benchmark for disclosure could be seen as applying EU requirements on an extra-territorial basis or as blocking non-EU firms from participating in "qualifying securitisations".

A response to the Bank of England and European Central Bank Discussion Paper
A case for better functioning securitisation market in the European Union
by the British Bankers' Association

Introduction

The BBA is pleased to respond to the Bank of England and European Central Bank Discussion Paper on the European securitisation market[1].

The BBA is the leading association for banks active in the UK. It represents over 170 banking members, which are headquartered in 50 countries and have operations in 180 countries worldwide. All the major banking groups in the UK are members of our association as are large international EU banks, US and Canadian banks operating in the UK as well as a range of other banks from Asia, including China, the Middle East, Africa and South America. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum from deposit taking and other more conventional forms of retail and commercial banking to products and services as diverse as trade and project finance, primary and secondary securities trading, insurance, investment banking and wealth management. As well as banks headquartered in the UK our members include third country banks which operate in the UK many of which are involved in the securitisation markets either as issuers or investors, so this discussion paper is relevant to the activities of many of our members.

Key messages

The BBA strongly supports the Bank of England and European Central Bank discussion paper which could herald an important and overdue rehabilitation of the European primary and secondary securitisation markets. The European securitisation market performed as expected, from a credit perspective, during the global financial crisis but was contaminated by association with the US sub-prime mortgage-backed securities market.

A revitalised European securitisation market would directly benefit the real economy by enabling banks, as originators and issuers, to better manage both capital and liquidity aspects of their balance sheets allowing them to create more lending capacity.

Without greater investor involvement the securitisation market will not realise its full potential. Of significant concern are the *capital charges* proposed by Solvency II which significantly exceed the capital an insurer would be required to hold against the underlying portfolio. These should be halved to bring them into line with other similarly rated bonds. Similarly we believe that capital charges for banks' investments in securitisations should be recalibrated downwards. Ideally capital requirements should be risk based and blind to the type of investor, emphasising the need for a coherent approach across the financial services industry.

[1] http://www.bankofengland.co.uk/publications/Documents/news/2014/paper300514.pdf

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The creation of a '*qualifying securitisation*' category, benefitting from preferential capital and liquidity treatment for bank investors, would make a major contribution to revising secondary market liquidity. A higher LCR buffer credit, which aligned the treatment more closely with covered bonds, would be most beneficial. The qualifying securitisation definition should build on the PCS initiative's excellent work.

A key component in successfully structuring a securitisation that meets both investor and issuer requirements is the provision of a swap facility, the collateral requirements for which have become punitive, increases the cost of credit for end users. This could be alleviated were *central banks to guarantee counterparty exposures* or alternatively act as the swap counterparty. It would also be beneficial were central banks to provide cash accounts to SPVs.

We support the premise that securitisation markets should be simple and transparent we do not agree that all *synthetic securitisations* should be excluded from the 'qualifying securitisation' category. Synthetic securitisations can be simply and transparently structured and are used by banks when the physical transfer of assets to the SPV is operationally complex.

We support the principle of *globally harmonised standards* in relation to the risk weighting, liquidity characteristics, retention and reporting of securitisations, regardless of the type of investor. But if this is not achievable in the near future, consideration should be given to adopting a 'Europe only' approach, which should encompass banks, insurance companies and pension funds.

The BBA looks forward to working with the Central Banks in the important task of creating a better functioning securitisation market for Europe.

Response to questions

- Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?

Yes Section 2 identifies the key benefits of securitisation which we would characterise as:

- Risk diversification and transfer
- Duration matching
- Funding diversification
- Capital optimisation

During the financial crisis funding diversification was the main motivator for BBA members as they retained securitisation instruments on their balance sheets in order to access central bank liquidity.

However as the economy recovers and investment picks up banks will be faced with the dilemma of wanting to lend more to the real economy, which is one of the key roles they undertake for society, whilst at the same time raising more capital, particularly in mainland Europe, to repair balance sheets. So in the near future capital optimisation will become a predominant motivator for securitisation by banks. This will allow them to increase lending capacity beyond the constraints of the capital base of the banking system.

This capital redeployment in our view is the principle mechanism by which securitisation will enable more lending to SMEs which will be an indirect consequence of a better functioning securitisation market. We do not expect to see, in the immediate future, significant appetite for securitisations backed by pools of SME loans, although there may be certain types of underlying assets – for instance car loans backing floor-plan financing arrangements for small automotive dealers – that would directly benefit some SME types through an expanded European securitisation market.

- Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?

Yes we agree with the impediment identified in paragraphs 72 to 82 which in short are:

- Unclear Solvency II requirements for insurance investors
- Limited secondary market liquidity
- Overly conservative risk weighting proposals for securitisations when held by banks as investors

The most concerning of these are the proposed Solvency II capital charges for insurers holding securitisations. If these are not recalibrated across the capital structure (including mezzanine tranches), there will be very little appetite from this important investor segment. As discussed in more detail in a recent AFME paper, we believe a halving of the current proposed capital charge for level 1 and 2 securitisations would bring relative returns into line with other similarly rated bonds and align the capital charges much more closely to the risk weightings of the underlying exposures. This is important as we do not believe that there should be a 'securitisation premium' for investing in the senior tranche of a securitisation structure compared to a similarly rated corporate bond.

We have similar concerns in relation to the risk weights that have been proposed by the Basel Committee for banks, which although lower than previous iterations, are still at too high a level in our view. This has been well articulated in a number of industry responses to the Basel Committee's recent consultation on revisions to the securitisation framework, including that of the International Banking Federation, available at:
http://www.ibfed.org/news/ibfed-response-to-the-second-consultation-on-revisions-to-the-basel-securit

The most readily solvable of the above impediments is the lack of secondary market liquidity. We support the suggestion that 'qualifying securitisations' would benefit from a higher liquidity 'credit' in the calculation of banks' liquidity buffers. Our preference would be to base this on the Commission and EBA's ongoing work on the identification of which securitisations are 'high quality and liquid' in the Liquidity Coverage Ratio (LCR).

We note that in paragraph 79 prepayment risk is identified as a possible impediment for investors. We do not think it is a material impediment; it is a long standing feature of the securitisation market, a risk that investors are comfortable in analysing and taking.

- Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?

The current differences between EU and US reporting and disclosure requirements are examples of regulatory uncertainty which we see as a major hurdle to the return of a well-functioning securitisation market, as is the differential application of retention requirements – on issuers in the US and on investors in Europe. This regulatory uncertainty undoubtedly increases the cost and complexity of bringing a securitisation to market, reducing its attractiveness as a funding vehicle.

Although the Discussion Paper focuses on the European securitisation market we see great merit in promoting a globally harmonised approach. So we encourage both the Bank of England and the ECB to pursue this goal robustly with the Basel Committee as it considers revisions to the securitisation framework. As these are not yet complete it is difficult for issuers to structure and price securitisations.

If however it does not appear that international approaches will be harmonised in the near further we believe a conscious decision may have to be taken to introduce a 'Europe only' approach, which whilst sub-optimal, will be of more immediate benefit to the wider European economy.

Significant risk transfer

Of similar concern is the fact that, despite the EBA's guidelines on significant risk transfer in securitisations (which are still draft form), the competent authorities in different member states take different approaches to their interpretation. This can mean that requests for approval of capital relief are met with varying degrees of scepticism and decisions not delivered in a timely fashion. We believe that the stigma still attached to securitisation is constraining supervisors and hampering its re-emergence as a potentially important funding tool. Continuing supervisory mistrust of this technique should be addressed. If the risk transmission process from issuer to investor is robust, capital relief should be granted and we hope that once the finalised EBA guidelines are released this will be the case.

GIC accounts

GIC accounts are expensive for commercial banks to provide given the credit rating downgrade triggers which require them to hold additional collateral and provide for this possibility in their liquidity buffers. Alternatively were central banks to provide GICs, banks' counterparty risk would be reduced freeing bank credit lines without the central bank taking on extra risk.

Swap counterparty availability

The Discussion Paper has correctly identified that the poor availability of the swaps that are required to transform cash flows is acting to the detriment of the European securitisation market by increasing the cost of the movement of capital and availability of funding across European borders.

This impediment arises from the requirement that a bank acting as the swap counterparty must itself maintain a certain minimum credit rating to be eligible as a counterparty for the derivative and provide for potential collateral posting on their downgrade within their liquidity buffers. This is felt particularly acutely in cross currency swaps.

This impediment could be relived were a central bank (or a supranational agency acting on its behalf) to act as counterparty to the swap to the SPV. The central bank's market risk would be managed through back-to-back swaps with the originating/sponsoring bank, written under credit support agreements based on market standard Mark to Market, with netting as an alternative to the currently applied penal volatility collateral buffers. A further beneficial outcome of central bank involvement could be the standardisation of securitisation swap documentation, reducing operating costs.

Alternatively, and perhaps more simply, central banks (or a supranational agency on its behalf) could consider guaranteeing the counterparty exposures.

Inferred ratings of ancillary credit facilities

Ancillary facilities ranking senior or *pari passu* to rated positions have historically been unrated. At the moment a rating can be inferred from a rated position, only where this rated position is subordinated in all aspects to the unrated facility. This results in a higher cost of capital for providing these facilities. Being able to infer a rating from a rated position which ranks *pari passu* to the ancillary service would go some way to ensuring a more appropriate capital treatment for these unrated positions.

- Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

Yes greater market liquidity will make securitisations more attractive to investors such as insurance companies and pension funds who always want to know that there is a vibrant two-way market in any investment they make, so that they can trade in or out if they decide to re-balance their portfolios.

We note that European proposals accord covered bonds a much higher liquidity credit than envisaged by the Basel Committee. We strongly believe that the inclusion of 'qualifying securitisations' with a higher liquidity credit in the LCR buffer will be the mechanism to provide market liquidity. This would expand the pool of buyers and sellers.

However offsettingly this may have the effect of reducing liquidity in non-qualifying securitisations, thereby increasing the cost of innovative or esoteric issuances.

- The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

We support simple, transparent structures and agree that the principles outlined in Box 3 are a comprehensive expression of how these might be identified, with such structures benefiting from less stringent capital and liquidity requirements. We support the non-exhaustive list of examples which we believe implicitly recognises, as we believe it should, that a qualifying securitisation should not be identified on the basis of the underlying asset type. In particular we would want to ensure that non-SME loans – i.e. loans to larger corporates should be eligible with in 'qualifying securitisations'. In addition, we strongly believe that the concept 'qualifying securitisations' should not universally discriminate against synthetic securitisations.

We note however that Box 3 appears to focus on the securitisation in its entirety, i.e. all the tranches in the structure. We envisage that the most senior tranche of qualifying securitisations should benefit from greater liquidity credit, whereas all tranches of a qualifying securitisation would benefit from comparatively less punitive capital charges.

- Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?

Yes, very definitely although we should be alive to the possibility that liquidity could transfer from non-qualifying securitisations to qualifying ones.

- These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?

We strongly support the work that has been undertaken by the PCS in developing common eligibility criteria which are supplemented by range of other asset or jurisdictionally dependent criteria. We believe that the PCS's approach could serve as a model for a regulatory approach, based on a 'base layer' of rules with an overlay of central bank judgement which could take into account the PCS eligibility criteria and the principles described in Box 3. This approach, which puts decision making power in the hands of central bankers and supervisors, reflects our implicit understanding that central bankers and supervisors are unlikely to wish to rely solely on the PCS's initiative – albeit that it is independent in nature.

As we have noted above the base layer for 'qualifying security' identification should be the Commission's identification of which securitisations are 'high quality and liquid' for LCR purposes. We would envisage that this definition could then be used for capital assessment purposes, for both banks and insurers, as well as for central bank eligibility purposes. The importance of having a common, multi-functional definition throughout Europe of 'qualifying

securitisation' should not be under-estimated and would be an important step in encouraging a better functioning securitisation market. Pragmatically much of the technical development work in relation to the definition of 'qualifying securitisations' will be undertaken by the EBA and we stand ready to help it in this task.

Care should be taken to ensure that established and vital business segments of the various product sectors are not inadvertently negatively impacted by this development. To provide a few examples:

- The regular use of embedded vs. standalone derivatives by corporates in relation to hedge accounting requirements should not be inadvertently excluded;
- The issuance of money market notes by Master Trusts (which naturally have a legal final maturity before the majority of asset maturity dates but are supported by cash reserves and extreme cash flow stress testing) should not be excluded;
- In relation to identifying self-liquidating assets it should be clarified that important product segments of the European mortgage market such as Interest only loans and the widespread feature of balloon payments in car loans are not excluded.

- Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?

We welcome the ECB and Bank of England's commitment to ensuring synergies and consistencies between the approaches to loan level reporting. Investors would be greatly assisted were there just one portal and one standard for data as the requirement to analyse significant amounts of data that is presented on a slightly different basis may act as a deterrent, particularly for smaller non-bank investors.

Similarly issuers would benefit from one approach to the data they provide. Requirements currently differ between central banks, supervisors and rating agencies.

- Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single

Issuers already maintain good investor reporting websites so we do not believe that there would be merit in having a single portal. However there could be merits in improving the 'front end' of central bank portals to allow easier manipulation of the data therein. Similarly links within the central bank portal to individual banks' issuer reporting websites would be a low cost improvement.

- Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?

We question the value of giving investors access to credit data as, particularly for consumer exposures, each bank will maintain its own scorecards making consistent analysis difficult.

- In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

No, we believe the current publication by the central banks of macro-economic data for countercyclical buffer purposes is sufficient and that the further supply of such data by banks would be duplicative and potentially confusing. Further reporting burdens will further increase barriers to new issuers. The focus should be on standardisation.

- Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

Indices have more applicability for 'rates' instruments. We see securitisations as credit instruments, which investors buy to hold, so are unsure of the usefulness of indices particularly as the European securitisation market is not currently exhibiting high liquidity. Development of indices *per se* would not improve this. If the market decides that indices would be helpful they will emerge in due time although we think the creation of a robust index would be difficult. The authorities should not seek to encourage their premature birth.

- Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

Whilst an interesting idea (particularly at new issuance rather than on a continuing basis) we believe that a ratings grid as suggested could cause confusion and distract attention from the fundamental linkage between systemic and country risk and the performance of the underlying assets and the rating of a securitisation, on which larger investors will have their own view.

- How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

We certainly agree that it is important that a pan-European mechanism be identified that carves SPV bank accounts out of a failing banks insolvency estate to the satisfaction of the rating agencies. One solution to this, which would avoid the potential large exposure and liquidity coverage ratio issues associated with holding the account at a commercial bank, would be to house the SPV bank account at the central bank. This would also relieve potential pressures in countries where there are only a limited number of banks acceptable for the holding of SPV accounts. Furthermore any collateral requiring to be posted with a central bank to support its guaranteeing of swap counterparty exposures could be posted to this account.

General questions

- With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?

We fully support the authorities' effort and desire for simple, transparent and robust securitisation markets but emphasise that synthetic securitisations, often used by banks for risk and regulatory capital management, can also enable banks to effectively transfer significant credit risk and free up regulatory capital in order to generate more lending capacity which can be critical to the growth of SME lending.

Synthetic securitisations that are well structured and transparent can be just as well understood by investors who are already provided with sufficient information to properly assess their risks. It is critical that policies considered by the authorities to promote securitisation, criteria to differentiate 'qualifying securitisations', or reporting requirements to improve transparency of true sale/cash securitisations do not inadvertently disadvantage well-structured synthetic transactions and harm banks' abilities to use synthetic securitisations for risk and capital management, when often operational or legal considerations prevent the physical transfer of an asset to an SPV.

- Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets? Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?

No, a revived European securitisation market is the best way to create the benefits to investors, issuers and the system as a whole.

- Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?

We offer some comments below on a number of the criteria examined in Box 3.

Underlying assets

The performance history sensibly requires information covering at least one period of market stress. Over such a lengthy period of time banks will have changed their scorecards and underwriting standards which could make a 'substantially similar' comparison difficult depending on how this test is applied.

These requirements could also have the unintended consequence of limiting competition from new entrant challenger banks.

Current assets only

Whilst the concept of being current in payment is absolutely correct there are some structures, for example credit card master trusts, where it is customary and market standard for UK credit card account portfolios as a whole (including individual receivables that may be delinquent) to be assigned. It would be operationally and practically very demanding to apply residential mortgage type eligibility criteria to a credit card master trust due to the much larger number of receivables and fundamentally different nature of credit card assets compared to other more granular consumer credit exposures. The current wording of para. 131 would prevent master trust based credit card structures being classed as 'qualifying securities' despite their exemplary performance throughout the crisis.

Similarly, depending on the specificities of the product and jurisdiction it is can be common to see a high level of 1 to 30 days past due (dpd) delinquency which occurs for technical reasons – e.g. a lower level of direct debit penetration. Finnish prime auto loans are a good example of this - prime portfolios can have a 1-30 dpd level of around 10% but this drops to around 0.5% by 90+dpd. Excluding 1-30 dpd loans would be a significant handicap to the originator without underlying credit risk based justification.

This issue can be overcome by utilising wording such as 'receivables should be no more than 30 dpd at the point of sale into the issuer' with a carve-out for credit card receivables.
We would be delighted to discuss more detailed wording if this would be helpful to the ECB and Bank of England.

Self-liquidating

The description of the "self-liquidating" principle could be interpreted in such a way that any loan with balloon payments would be excluded from a 'qualifying securitisation'. If that is the intention, we would strongly disagree with that concept. However, we do think that a 'qualifying securitisation' should minimise the impact of a loan's refinancing risk on note holders by allowing for a meaningful period between a loan's maturity date and the date on which the note is due and payable.

Prospectus directive

We support harmonised disclosure standards agreed upon by the Basel Committee and implemented in a globally uniform way.

But where compliance with the Prospectus Directive is not required, for instance in private placements, requiring disclosure to its standards is unnecessary and could restrict participation in the privately placed European securitisation markets by non-European investors.

External parties

In order to be classed as a qualifying securitisation, we support the principal of on-going independent credit assessment by agencies that are subject to the CRA regulations, however it must be understood that not all tranches within a structure will be rated.

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July 4, 2014

BBVA comments on ECB/BOE discussion paper "The case for a better functioning securitisation market in the European Union"

Key Messages

- We agree with the declared political aims on **the need to support the recovery of the securitization channel on a robust foundation**, particularly in Europe, as it could help filling the funding gap for SMEs and promote a balance between bank and non-bank financing.
- We **welcome the European Commission's approach to work on the differentiation of high quality securitization (HQS) and on the possible regulatory preferential treatment, compatible with prudential principles**. This approach is aligned with ECB, BoE and IMF declared support for a preferential regulatory treatment for high quality securitization.
- We are of the opinion that **Europe should take the lead in the definition of HQS and in the review of related regulations** to try to set up in the short term the right environment for a revival of a well-functioning securitization market, and leave it open for further review to accommodate possible agreements reached at global level (BCBS/IOSCO).
- We consider that **the focus of the political action should not be constrained to the most senior tranches** of securitizations that are simple and transparent, **but apply to the entire transaction**. Otherwise, one of the key potential benefits for the real economy of using the securitization channel would be jeopardized, if risk transference that enables further lending by banks in a context of scarcity of capital is unduly penalized. **Regulatory review should intend to treat fairly all the tranches of a HQS.**
- Consequently, **we agree with ECB/BoE approach to differentiate as Qualifying Securitisations (QS) those securitization transactions that are simple, structurally robust and transparent**, as they allow proper risks assessment by investors and other interested parties and are less prone to raise systemic risks, contrarily to complex and shoddy securitizations - as US sub-primes- that played a relevant role as triggers of the last financial crisis. **We consider that QS could play the role of being the core definition of HQS, agreed amongst regulators, and used systematically whenever it is possible.**
- **Regulatory preferential treatment for HQS should intent to lift regulatory penalising bias for securitisations**, comparing to other asset classes with similar characteristic, included in the current and forthcoming regulatory changes. It should be wide in scope to provide the right incentives to originate and invest in HQS. It should include banking regulation (capital and liquidity requirements) as well as regulations related to other institutional investors (e.g. Solvency II for insurance companies).
- Additionally to favoring standardization and overcoming the current regulatory hurdle to HQS, **we welcome any additional measures intended to favor the start up of a well-functioning securitization market**. Public sector involvement will be conductive to restoring confidence, and certain direct interventions, as outright buying HQS, would provide a welcome boost. Direct intervention should be suitably modulated over time to promote the revival of a sustainable ABS market, that should be based primarily on private sector participation on both the supply and the demand side.

- We consider that we should not miss the **opportunity to set the framework for the development of a truly European robust securitization market that could complement long term financing of the real economy.**

General Remarks

BBVA welcomes the opportunity to participate in the current debate on finding the best way to promote a well-functioning securitisation market in Europe. **We consider that this discussion paper is a very positive contribution to the path that the European Commission** launched in March 2014 and that recognized the important role to play by HQS as a key instrument to revive the funding to the real economy.

We appreciate the contribution of the paper analyzing what went wrong during the financial crisis, with the differentiated behavior of high quality securitizations in Europe that showed a strong performance, and the review of the steps already taken in Europe to address unveiled shortcomings.

We agree broadly with BoE/ECB analysis of the potential benefits that could result from the renewal of the market for the less complex products in Europe, as it could support greater funding diversification, free up capital to grant more credit and provide insurance companies and other institutional investors with investment assets with maturities and returns that match their liabilities profile. It could produce clear benefits to the real economy, complementing other long term funding sources.

Indeed, **we are aligned with the conclusion**, following the analysis undertaken by BoE/ECB, **that policy measures are necessary** to overcome current regulatory and market barriers that are preventing the revitalization of ABS activity in Europe, and that those measures should intend to promote the reactivation of an European market on a solid foundation. **Consequently, we welcome the opportunity to discuss the range of measures proposed in the discussion paper and aimed at promoting a robust securitization market in Europe.**

We consider that greater standardization of ABS products is a key goal to stimulate greater market activity. Thus, **we are of the opinion that creating a separate market for standardized simple and transparent HQS, while removing the regulatory roadblocks that could deter investors and originators interest in them, is a necessary step to be taken without much delay**.

For this purpose, we consider of the most importance **a coordinated approach among EU policymakers and regulators to agree on a definition of HQS and to undertake a comprehensive review of the set of regulations that affect HQS** in Europe, in order to improve the regulatory environment and mitigate as soon as possible the regulatory uncertainty surrounding ABS. **Europe should move ahead swiftly in addressing inconsistencies in the treatment of HQS**, leaving the door open to possible reviews in the future, should the BCBS reach an agreement on a similar framework.

We agree with the BoE/ECB approach of differentiating transactions that are simple and transparent (Qualifying Securitisation- QS) and consider that QS could be the core definition of HQS for regulatory purposes, and that a preferential regulatory treatment should be considered for HQS, commensurate to their characteristics. Additional measures considered in the paper to improve transparency and standardization are valuable contributions, some of them being discussed in more detail below.

Detailed comments

Below we comment on some of the questions raised in the discussion paper.

1) On the definition of 'qualifying securitisation'

As we consider that **the focus of the current aim of reviving ABS markets should not be constrained to the most senior tranches but apply to the entire transaction**, not to discourage the use of securitization as a risk transfer mechanism that facilitates banks granting new loans to the real economy, **we fully support the concept of 'qualifying securitisation' (QS) applying to entire ABS transactions.**

We consider that QS should play the role of being the core definition of HQS, agreed amongst regulators, and used systematically whenever it is possible, and **we agree with the proposed definition** that stresses the convenience of enabling investors an informed assessment of risks assumed and expected returns, in order to provide confidence on the behaviour of the assets they are investing in, considering a wide variety of potential economic conditions.

For that, simplicity, structural robustness and transparency are crucial. **We consider that a definition based on high-level principles**, that manages to exclude risky securitization practices and prevent weaknesses unveiled in the past, would facilitate its use by regulators and best accommodate the diversity of jurisdictions and assets involved, **without relying in a complex set of prescriptive criteria.**

In relation to the **principles included in Box 3** of the Discussion Paper, we largely support their convenience. However, we would like to comment on some of them and suggest some additional principles to be considered.

- Concerning external parties involvement, we consider that the required independent credit assessments by **at least two credit rating agencies could be relaxed until requiring only one**, reducing thereby issuance costs and recognizing the greater emphasis on due diligence that has to be conducted by investors.
- We wonder if an **additional criteria should be included, requiring originators to retain a substantial economic interest in the securitization** in order to prevent the proliferation of pure originate-to-distribute models that could undermine the quality of underlying assets. Even if it is true that several European regulations include the retention of at least a 5% of the economic interest, **we consider that it should be an intrinsic characteristic of any QS**.
- Another **additional principle** that could deserve being included is **a limitation of the maturity mismatch** to prevent an excessive exposure to refinancing risk.
- Finally, **we support the general principle of exclusion, at the time of issuance, of non-performing loans** but we consider that this principle should be understood in the sense that underlying loans and receivables **should not be in default, as defined in the prudential regulation** in order to achieve consistency and promote harmonised implementation. This approach to relate non-performing loans with prudential definition of

default has **already been taken by EIOPA** for its recommendations for type A securitisations under Solvency II.

European prudential regulation, Article 178 of Regulation (EU) No 575/2013 (CRR), considers **a loan being in default** when the institution concludes that the obligor is **unlikely to pay its credit obligations or when the obligor is past due more than 90 days on any material credit obligation**. The regulation additionally provides discretion to national competent authorities to replace the 90 days with 180 days for some asset classes – residential or SME commercial real estate- and we consider that this discretionality should be disregarded for QS definition to favour harmonisation.

2) On the convenience of certification and public sector involvement

We consider **that a certification mechanism should be considered to ensure a unique and transparent interpretation of the principles included in the definition of qualifying securitisation, and thus help rebuilding trust.** A credible independent certification, that provides an accurate assessment in an efficient way and in a short period of time, and that is freely available in a single location, would undoubtedly promote operability and liquidity of these transactions.

To achieve this goal, we are of the opinion that a **workable framework could be to derive the daily work of certification, understood as solely assessing compliance with existing regulatory definitions, to a private sector entity**, but subject to public sector control. Using an experienced private sector company as a certification agency instead of public sector direct certification, would entail some advantages, as is the fact that it could adapt quickly and be operational in a reasonable time frame, it could be easily scalable to attend changing market requirements and it could charge the service offered to the market in an efficient and transparent way.

Nevertheless, public sector involvement is fully recommendable, as it is the one that has the last word when interpreting the regulatory definition; for instance, assisting the certification agency in any issue of interpretation or when the issuer/investor do not agree with the work of the certification agency. The convenience of the presence of public sector representatives in the decision bodies of the certification agency and the surveillance of its governance arrangements should also be considered

We think that PCS is in the best position to play this role of certification agency in Europe due to its ample experience in labelling high quality securitisations and solid reputation. Besides, its corporate structure, internal code of conduct and the fact that it is a 'not-for-profit' entity ensure the absence of material conflict of interest.

3) On facilitating investors' access to credit registers

While we are in favour of facilitating investors access to all information required to assess risks and returns of ABS, we believe that, prior to broaden the sources of information available to investors, **it should be considered what has already been achieved and the ongoing current proposals to increase transparency, in order to avoid duplications and ensure that usable information is provided in a cost-effective manner.**

Since the crisis, **several improvements in transparency have been implemented in Europe.** The **new prudential regulation** – Article 409 of CRR- has incorporated a requirement for originators to make sure that investors have readily available access to all materially relevant data to carry out a comprehensive due diligence and effectively manage risks. Besides, it is undeniable the positive contribution in this regard of ECB and BoE transparency requirements for securitisation instruments which are eligible for repo facilities with central banks, and its catalyser effect on the establishment of the privately run **European DataWarehouse**, that is a valuable information source for European securitisations with a scope that is widening from day to day.

We would also point out that there are currently in Europe ongoing public initiatives to promote greater ABS transparency, which should not be dismissed, as is the case of the **forthcoming increased disclosure requirements for securitisation**, as mandated by Article 8b of **CRA regulation** (Regulation 1060/2009), for investors to make informed assessments on the creditworthiness of structured finance instruments and reduce reliance on credit ratings.

Consequently, in our opinion **it does not seem necessary to consider the access by investors of an additional information source, as would be the case of credit registers,** also taking into account the legal difficulties that can generate the public access to them, mainly associated with the compliance with no harmonized data protection laws, for instance in relation to the preservation of borrowers confidentiality rights.

4) On additional information on credit ratings

We consider important that credit rating agencies are encouraged to publish additional information, as the matrix suggested, to complement heading ratings and help investors assess the effect on ABS ratings of sovereign and counterparty caps, included in the rating methodology of several agencies.

We understand that it is agencies' prerogative to decide on the methodology to be used to assess risk. Likewise, it is prerogative of the authorities to use those ratings in regulation or introduce certain corrections to them to achieve their objectives, deserving special attention the mitigation of systemic risks and the consolidation of the banking union to help alleviating the banking-sovereign risks feedback.

In the case of ABS rating, we consider that certain practices followed by credit rating agencies are questionable and give rise to potential systemic risks. This would be the case of the practice of constraining ABS ratings by the rating of the corresponding sovereign, which could deter ABS issuance in stressed economies, preventing the viability of a complementary channel to finance real sectors when most needed. We consider that this practice may induce double counting of risk, if country risk is already and adequately being captured in the credit risk assessment of the pool and third parties to an ABS transaction.

Following this, we would recommend going beyond encouraging additional information, to **establish a mandatory disclosure, for credit rating agencies assessing ABS, of the rating in the absence of the sovereign ceiling.** Besides providing more transparency for investors, allowing them to filter out the sovereign cap if they wish to do so, it would **enable regulators to consider this rating as the reference in regulation** instead of the currently considered heading ratings. This would help to neutralize the negative effect of the raise of capital requirements of ABS with underlying assets located in stressed countries irrespective of their overcollateralization, largely due to rating agencies practices that translates to ABS ratings the sovereign ratings' downgrades. **Moreover, this would help moving towards the overall objective of the global regulatory reform of reducing mechanistic reliance on credit rating agencies.**

Central banks could take the lead in this direction, referencing to these uncapped ratings the haircuts applied to repo operations with ABS.

5) On the availability of ancillary facilities

We share the analysis of the several constraints that could have an impact of reducing excessively the availability of counterparties eligible to provide ancillary services to an SPV, being one of the most relevant the rating requirement.

The paper focuses on exploring the use of bank accounts that legally fall outside the insolvency estate of their provider, thereby enabling more counterparties to be able to provide them to SPV. One of the ways to achieve the goal could be to **change national insolvency laws to establish a preferential treatment for SPVs in relation to bank accounts, which could have a beneficial impact but possibly of moderate quantitative relevance.**

Other possible ways to explore, **as outsourcing of certain ancillary services** (swap counterparties and bank accounts), **could be considered, but only if subject to conditions that are supported by written clauses and activated by triggers related to the deterioration of the insolvency of the provider**. We would fully discourage the consideration of a mandatory and unconditioned outsourcing of these services because it would be unnecessarily costly and would not prevent systemic risks as those services, once externalised, would be covered mainly by banks.

BLACKROCK

7 July 2014

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RE: ECB-BoE discussion paper on "The case for a better functioning securitisation market in the European Union"

Dear Sirs,

BlackRock is pleased to have the opportunity to respond to the ECB-BoE discussion paper on "The case for a better functioning securitisation market in the European Union".

BlackRock is a premier provider of asset management, risk management, and advisory services to institutional, intermediary, and individual clients worldwide. As of 31 March 2014, the assets BlackRock manages on behalf of its clients totalled £2.64 trillion (€3.20 trillion) across equity, fixed income, cash management, alternative investment and multi-investment and advisory strategies including the iShares® exchange traded funds.

BlackRock has a pan-European client base serviced from 22 offices across the continent. Public and private sector pension plans, insurance companies, third-party distributors and mutual funds, endowments, foundations, charities, corporations, official institutions, banks and individuals select BlackRock to manage their investments on their behalf.

BlackRock represents the interests of its clients by acting in every case as their agent. It is from this perspective that we engage on all matters of public policy. BlackRock supports policy changes and regulatory reform globally where it increases transparency, protects investors, facilitates responsible growth of capital markets and, based on thorough cost-benefit analysis, preserves consumer choice.

To give a brief summary of our views and recommendations on securitisation, BlackRock believes that securitisation alone is not a panacea for the European corporate funding gap. However, along with other initiatives to stimulate growth such as the corporate bonds and equity markets, securitisation can be an additional tool for funding European companies. Healthy securitisation that promotes economic growth can be realised if:

- securitised product offerings consider and protect the needs of investors as well as those of the originator and sponsors;
- the various policy measures that affect securitisation in Europe are consistent and do not deter the responsible use of securitisation; and
- regulation properly accounts for differences between securitisation and other types of assets.

In a thought piece which we recently published entitled “Securitisation: a tool for European growth”[1], we recommend to policymakers the following guiding principles designed to both protect the rights of investors in securitised assets and to promote economic growth through use of securitisation:

- Set out high-quality, prudent underwriting standards that are evaluated and administered properly.
- Establish quality servicing standards.
- Ensure transparent and accessible asset and transaction information.
- Ensure conflicts of interest are identified and managed properly.
- Ensure structures are clear, complete and presented in an understandable manner.
- Appropriately align originator, sponsor or original lender and investor interests (with originator, sponsor or original lender risk retention, where applicable).

BlackRock agrees with the benefits of securitisation and the obstacles to the re-launch of securitisation outlined by this discussion paper. We provide specific comments in our detailed response on each of the high level principles for qualifying securitisations, set out our views on a “qualifying securitisation” certification and recommend how such a certification might be most helpful for investors.

We are in favour of standardisation of information disclosure and highlight in our response a number of conditions that must be met in order for investors to make appropriate investment decisions. We also support making data on underlying assets available to investors so that they can make informed decisions about the likely credit performance and thus cash-flows from a pool.

As an additional element of transparency, we recommend that data underlying ratings decisions (that is not truly proprietary) should also be disclosed to investors. This would allow investors better insight into a rating agency process and the accuracy of its data analysis, thereby creating incentives to enhance the credit ratings process.

We would, however, like to share two concerns pertaining to data. First, we would highlight the risk that unnecessary levels of data might be produced, adding complexity and undermining the ability for investors to gain a holistic and meaningful picture on the underlying assets. Second, data alone is not sufficient. Investors also require qualitative information, for example, regarding a bank’s criteria and underwriting processes, in order to reach a credit decision.

[1] Securitisation, a tool for European Growth, March 2014 : http://www.blackrock.com/corporate/en-gb/literature/whitepaper/securitisation.pdf

We appreciate the opportunity to address, and comment on, the issues raised by this discussion paper and we will continue to work with the ECB and BoE on any specific issues that may assist in improving final public policies enhancing a better functioning securitisation market in the EU.

We would welcome any further discussion on any of the points that we have raised.

Yours faithfully,

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BlackRock detailed response to ECB-BoE discussion paper on "The case for a better functioning securitisation market in the European Union"

Motivation

1. **Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?**

   BlackRock agrees with the benefits of securitisation outlined in the discussion paper. From the investor's perspective, securitisation provides a means of diversifying exposures. More specifically, we believe that securitisation potentially increases the availability of highly rated bonds by providing a mechanism to separate highly rated assets from a lower-rated originating entity. This presents investors that wish to (or are required to) invest in only highly rated assets with access to a larger and more diverse pool of investment options. It also allows investors to invest in diversified pools of assets (for example pools of mortgages) without having to bear the credit risk of the company or bank that originally made the loans.

   We agree that securitisation can be a useful funding tool for banks and non-banks. Securitisation makes cash flows that would otherwise arise in the future available for immediate re-investment. It also affords some relief from asset and liability management challenges for long-term, fixed-rate assets. By bundling up cash flowing assets and selling them as securities to investors, banks also free up capital for additional lending. High quality securitized assets, either retained or purchased, also serve as liquid collateral for the banks to obtain funding from other banks and/or from the European Central Bank.

   Securitisation facilitates companies' access to capital markets at potentially attractive costs relative to other funding alternatives, as the rating on many of the securities issued is often higher than the rating of the originator of the securitisation. This is due to the collateralised nature of the securities issued, the credit enhancement, structural protections and the bankruptcy-remote nature of the issuer. In other words, securitisation allows companies to borrow at rates corresponding to the credit rating of their structured cash flows. Moreover, the benefits of securitisation related to credit risk transfer and cost of funding can often filter down to the underlying originator's customers in the form of more attractive borrowing costs.

   Securitisation can be a valid alternative to bank funding along with other sources of financing, such as the corporate bond and equity markets and play a key role in filling the current corporate funding gap in Europe. However, it will only do so if investor interests are appropriately considered and protected.

Barriers to a well-functioning securitisation market in the EU and economics of securitisation

Impediments to investors

2. Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?

BlackRock agrees with the obstacles to the re-launch of securitisation and concerns of investors outlined by this discussion paper. The regulatory regime around securitisation is not always coherent and supportive of securitisation. It does not consistently provide properly calibrated incentives for investors to allocate capital to securitised instruments.

For example, Solvency II rules will significantly increase the amount of capital that insurance companies are required to put aside for certain securitised exposures vs. the underlying loans. This has already deterred insurance companies from allocating capital to securitisations.

Under Basel III, the Liquidity Coverage Ratio (LCR) for banks allows for the inclusion of highly rated Residential Mortgage Backed Securities (RMBS) as long as the underlying loans have a Loan to Value Ratio (LTV) that is below 80% and all the loans are full recourse. This requirement is an arbitrary measure of risk, focusing on just one predictor of default out of many, which will deter banks from investing in pools of RMBS that historically have low losses and may also have high LTVs.

We note that many securitisations of SME loans in Collateralised Loan Obligation (CLO) formed over the past few years have primarily focused on banks packaging loans as collateral in order to access the ECB funding window. Recently, there have been a handful of publicly placed deals. Growth in this market will depend on greater standardisation, enhanced transparency and homogeneity in SME lending criteria and policies as well as measures to address information asymmetry and any mis-alignment of interests. Even with these improvements, it is important to recognise that this securitisation channel alone will not meet all of the demand for SME financing in the EU as SME pools are by definition more heterogeneous in nature leading to significant challenges in addressing information asymmetries.

We see that a number of policy makers focus on SME CLOs as being the main source of securitised funding to SME. However, this neglects the fact that there are many securitisations of leasing assets (auto and to a lesser extent, equipment) whose underlying obligors are primarily, or completely, SMEs / corporates. In addition, the role of ABCP should also be taken into account. ABCP allows banks to finance the loans and receivables of SMEs from a broad range of countries in which they might find difficult to lend to directly. The significance of this role is demonstrated by the fact that some ABCP conduit pools benefit from supranational guarantees.

We note that ABCP is not term securitisation. But ABCP does share similarities with term securitizations in certain structural characteristics, certain assets in the underlying pool and especially in the benefits it affords to the capital markets and overall economy.

However, we would stress that the low issuance volume of securitised assets in the EU is not primarily due to low investor demand but to:

- the weak macroeconomic context resulting in low volumes of credit originated;
- the obligations for banks to shrink their balance-sheet in order to meet the new Basel III leverage ratio requirement; and
- banks' easy access to central bank funding.

Banks are more focused on reducing their leverage ratio than freeing up capital for additional lending via securitisation and therefore we do not believe that the willingness of bank originators to securitise assets will increase in the near future.

Impediments to issuers

3. Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?

BlackRock agrees with the impediments highlighted in the paper and consider this a fairly comprehensive list.

Market liquidity

4. Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

BlackRock believes that solely looking at trading volumes as a measure for liquidity can be misleading. As highlighted in the paper, many investors are not looking to regularly trade positions once invested and we agree that this is in many cases due to the buy and hold or long-term investment nature of the portfolios. Another factor is the reasonably fast pay-down of many of the consumer asset backed transactions which means that portfolio rebalancing can be undertaken without the need for material trading. That is not to say that liquidity is not important – it plays a key part of the investment decision.

Policy Options

Identification of high-level principles of 'Qualifying securitisation'

5. The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the

principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3? Do these principles seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?

BlackRock agrees that it is critical for investors to understand, based on a range of scenarios and consistent and predictable key performance matrices, the risk and pay-offs of the securitised assets in which they invest. We would see this as a necessary condition for investment. The discussion paper gives the following characteristics of ‘qualifying securitisation’: “should be simpler, more structurally robust and transparent, enabling investors to model and understand with confidence the risks incurred. They could also potentially be less risky, due to higher quality of underwriting standards”. While we agree with most of these characteristics to define ‘qualifying securitisation’ we believe the term “simpler” is too vague and not appropriate in the case of securitisation. We would replace this with the expression “not over-engineered.

BlackRock has developed global guiding principles for policymakers to both protect the rights of investors in securitised assets and promote economic growth through use of securitisation. We detail them in our ViewPoint attached to this document:

1. Set out high-quality, prudent underwriting standards that are evaluated and administered properly.
2. Establish quality servicing standards.
3. Ensure transparent and accessible asset and transaction information.
4. Ensure conflicts of interest are identified and managed properly.
5. Ensure structures are clear, complete and presented in an understandable manner.
6. Appropriately align originator, sponsor or original lender and investor interests (with originator, sponsor or original lender risk retention, where applicable).

Please see below detailed comments on each of the principles outlined in box 3:

(1) Nature of assets

We do not fully understand the rationale behind limiting the underlying assets to rental payments or principal and interest payments although we fully support the requirement for the receivables to have properly defined terms. We would highlight the very common practice (in very well performing transactions, particularly in the auto sector) of selling zero interest rate loans (and/or those with very low rates) into a transaction at a discount to their face value so that the cash flows from a transaction perspective contain a different principal and interest stream to that seen by the customer. This is designed to allow the derived interest stream to be sufficient to cover the note coupons. We would suggest that any definition in this regard should not exclude these types of assets.

We agree that the interest calculation on the assets within a deal should not reference exotic derivatives.

(2) Underlying asset performance history

We fully support the requirement for investors to have access to historic performance data and would suggest that this should (where relevant) encompass defaults, recoveries and net losses on a vintage basis together with arrears and prepayment data. To the extent that the securitised pool contains sub-classes of assets that have (or may be expected to have) performed differently (e.g. consumer vs. corporate leasing, or car loans vs. truck loans) the historic data should be shown separately for these sub-classes since the business mix of the historic data may have changed over time and/or not be consistent with the securitised pool.

(3) Primary obligors

We fully support the requirement that qualifying securitisations should have recourse to the ultimate obligors and would highlight that the ability to take control over the underlying assets in enforcement scenarios gives much better protection to investors. We are therefore supportive of not considering synthetic securitisation as “qualifying securitisation”.

(4) Expectation of payment

We believe that within a qualifying transaction, the homogeneity of assets should, in addition to asset type, reference one originator group and one jurisdiction and be governed by the laws of and denominated in the local currency of that jurisdiction.

We agree with the requirement that the obligators have to satisfy prudent and consistent underwriting criteria including an assessment of willingness and ability to meet their obligations. We are unsure as to the reason behind having granular pools of retail consumers, for which the expected cash flows have been modelled, to meet the stated obligations of the securitisation under prudently stressed loan loss scenarios. We would still expect the retail customers to have been prudently underwritten on an individual basis.

(5) Current and self-liquidating

We are of the view that the principle of selecting only receivables that are current in payment is sensible although we wonder whether this needs to be defined since “current” is defined differently in transaction documents. Our understanding is that this criterion applies only at the point of asset sale and therefore does not impact master trust structures (other than eligibility for new asset sales) where by their nature notes will be issued against a pool which contains some arrears.

In terms of assets being self-liquidating from intrinsic cash flows we would like to further understand the thinking behind this and understand the implications for interest-only or balloon loans. The terms of a such loans clearly state that the loan is repayable (i.e. an intrinsic cash flow) although there may be cases (such as certain short term commercial real estate loans, working capital SME loans or balloon loans in auto transactions in particular) where the borrower relies on re-financing or an asset sale to meet this obligation.

Separately, we are unsure whether limiting the ability to securitise the residual element of leasing contracts is also a deliberate aim of the criteria.

(6) Security

Subject to interpreting this principle as meaning that only underlying assets having first ranking or first and subsequent ranking security right should be considered as secured assets, with any others as unsecured, we do not consider this an unreasonable credit approach. However, given that the value attributed to the security forms part of the underlying credit and risk analysis, rather than being a matter of fact, we are not sure how it would be implemented as a principle. As written, the principle seems to exclude any non-first lien security from qualifying – this would have a detrimental impact of transactions (particularly in SME space) where property security is given as part of a loan security package since this is frequently not first lien.

(7) Perfection of interest

Similarly to the principle on primary obligors, we support the principle of true sale. However, it is possible to achieve a sale under the laws of many jurisdictions without the security interest being perfected. So long as there are appropriate triggers for perfection of security and, prior to this, there is a requirement for the legal title holder to act for the benefit of the beneficial owner, we do not feel that perfection of security should be a requirement at the close of a transaction. For example prime UK RMBS is usually effected by a non-notified true sale where the borrower is not told of the sale and the security interest remains registered to the original lender (i.e. not perfected) but this is subject to trigger events such as originator ratings downgrade, insolvency, change of law, trustee concern for the security.

(8) Observability

In addition to the items highlighted in this principle we would suggest: scheduled principal received (in addition to that due), scheduled interest received (in addition to that due), repurchases (for example of receivable or secured asset e.g. lease residual value), recoveries (sale proceeds, and direct obligor recoveries separately where relevant), each as relevant to the transaction.

(9) Debtor payments

We interpret this to mean that there should be full disclosure of the servicing and administration process for the receivables and we fully support this principle. We wonder whether there should be any minimum standard to these processes as highlighted in our comment under (15) below.

(10) Payment priorities

We are in full agreement with this principle and would suggest, in line with the Bank of England transparency standards, that any items senior to note-holder payments (e.g. servicing fees etc.) should be disclosed (or at least confirmed to be under a capped amount in the case of commercial sensitivities) in order that investors are able to quantify likely cash flows.

(11) Rights

We believe that it is critical to preserve creditor hierarchy with respect to seniority and that all rights and remedies for note-holders must be appropriately disclosed and protected.

In terms of voting and enforcement rights relating to the assets being transferred we would caution that in most cases, prior to perfection of security, the SPV as purchaser of the asset will likely not have direct enforcement rights against the obligor but the legal title holder should be obliged to enforce in its name for the benefit of the SPV. This construction is the basis for virtually all securitisations, has been tested in various courts and seems to be appropriate for a "qualifying securitisation". We agree with the sentiment of this principle but suggest the wording may need to be clarified.

(12) Initial Data & (13) Ongoing data and information

BlackRock fully supports these principles and has been vocal in the need for appropriate loan level or granular stratification data (as appropriate) and cash flow models to be made available to investors and prospective investors prior to closing and on an ongoing basis.

We believe that it would also be useful for the investor report template to be given to investors as part of the marketing so that any shortfalls in information can be addressed. One element that appears to have been missing in the drive for disclosure so far is any quality requirements. There are frequently cases where investor reports contain numerous fields of potentially useful information but the numbers within the report or from one report to the next sometimes do not tie out. Rather than seeking to impose a regulatory quality standard, we would support initiatives for cash managers / trustees / servicers to be incentivised to ensure the quality of their reports.

Lastly, we would suggest that all investor reporting should be accompanied by up to date contact details for someone that is able to answer any investor queries on the information supplied.

(14) Conformance with prospectus directive

We support this principle although we would also welcome a review of the requirements of the various directives and initiatives governing the content of offering circulars. We are concerned that transparency is being neglected despite the efforts of full disclosure and that the length of these documents may (unnecessarily) become an impediment to investment.

(15) Servicing and counterparties

We would like to raise concerns with regards to the following statement: "The servicer should apply the same servicing policies, procedures and standards to the underlying assets that it applies to other similar non-securitised assets". While we applaud the efforts to minimise conflicts, we do not believe that this proposal sets a standard or is a particularly strong statement.

As it stands, this principle does not give any best practice requirements. It assumes that the servicer has assets of its own that it is servicing to a similar level and that it cares about from a returns (rather than a servicing fee) perspective. It is not clear how the principle works in the context of a third party servicer. We also believe that this approach misses the potential mis-alignment of interest that can impact servicing decisions (i.e. if another business area exerts influence over the process for a non-servicing related outcome which works at originator level but would be to the detriment of the securitisation).

This principle would not give a minimum level of comfort for our own investment purposes; we assess whether we think the process is appropriate on a case by case basis. One statement that already exists within many sets of documents is the “at all times acting in accordance with the standards of a reasonable, prudent mortgage lender”. This is stronger than the current proposal and would at least benchmark to some sort of market standard.

We fully support full disclosure of all relevant parties, their roles and responsibilities.

(16) External parties

External credit assessment
Although we do not rely on the credit agency review to form our investment decision, the rating is useful for our underlying clients (and frequently forms part of mandate agreements) in addition to providing almost a “gatekeeping” service for the market in performing an independent review for the underlying transactions documents. Therefore we also support the principle that qualifying securitisations should be rated.

Review of terms by Calculation Agent
Review of terms by the calculation agent should be business as usual but does not per se give investors additional protection given that some of the calculation agents have had interpretation issues with documented waterfalls and quality problems in their investor reporting.

Another principle that we would suggest for inclusion would be to limit the use of derivatives within structures to genuine hedging (e.g. interest rate, currency) only. Ideally, swaps should have a zero mark to market value at deal close (to avoid credit support being “hidden” in a hedging transaction). Care will be needed in drafting any such principle to avoid excluding the TRS swaps that generate pre-determined excess spread that are market standard in for example Dutch RMBS.

In addition, we would also recommend that the trustees and SPV are from a different corporate group from the sponsors’ to avoid any conflict of interest.

6. **Do respondents think that a liquid market for 'qualifying securitisations' available for funding would benefit from a 'qualifying certification'?**

   If a uniform qualifying securitisation definition (perhaps with additional "modules for specific purposes") is adopted and used for capital/liquidity/regulatory etc. purposes, then having it independently certified prior to or at closing (after closing is of no use) would be a strong positive. This would increase investor confidence that the transaction is indeed qualifying. The fact that there is a penalty for investing in a non-qualifying securitisation in terms of capital etc. for investors means that they may not be comfortable making judgment calls on some securities. Certainty in this respect, it should increase investor appetite and help support secondary liquidity.

7. **These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?**

   There are two key elements to any such certification. One is the risk of re-characterisation – investors need to have absolute comfort that the certification once awarded will not be taken away leaving them in the situation that they have to hold additional capital /fire sell a non-qualifying asset. The second leg is that any certification must be given on a timely basis. It needs to be available to investors at the start of the marketing phase, possibly finalised at closing. The process for obtaining certification must be quick – probably no more than a week or two in order that the process does not delay the bringing to market of a deal. To the extent that the process is overly cumbersome, costly or protracted, the issuer will be dis-incentivised from obtaining the certification.

<u>Standardisation of information disclosure</u>

8. **Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted?**

   We are in favour of standardisation of documents, structures and investor reporting wherever this can be achieved without limiting the flexibility of deals to cope with the differing products and legal jurisdictions that are currently contemplated in the securitisation market (or may be in the future). In terms of investor reports, there are clearly fields that are common to virtually all transactions and standardisation of some of the definitions and required fields would be useful. Full standardisation is problematic since templates are either i) so large in order to capture all options that they are unwieldy or ii) simplified to the lowest common denominator.

   A central repository for investor reports – e.g. the EDW – would aid access to information and ensure appropriate availability. It may then also be possible to implement some type of low level audit which could serve as a quality indicator (for example checking that the asset balance carried forward from the previous report is the same as that brought forward in the current one; that the reported movement in assets is equal to the movement in liabilities etc.).

How can accessibility to the existing loan level data be improved, so that it provides most value to investors?

The ability to easily stratify, drill down into or manipulate the data available on the EDW would be a material benefit to the investor community – particularly to small investors or new entrants who do not have the capacity to easily manage such large volumes of data internally. A user friendly software interface – with the basic functionality free to market - to analyse data within deals or between deals would greatly improve the usefulness of this information.

We would however caution that the first stage probably needs to be to overcome some of the data corruption that currently appears to be a problem in some of the uploaded data.

A further stage, once sufficient historic data has been gathered, could be to develop statistical models allowing investors to analyse the performance impact of certain loan characteristics over time to enable the development of predictive models with which to analyse pools.

9. **Do respondents think that initiatives currently undertaken by authorities in this domain are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?**

   We would consider current initiatives undertaken by authorities in this domain as going in the right direction but could be improved further. We give a recommendation above in responses to questions 7 and 8.

10. **Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? & 11. Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?**

    We strongly support the availability of data on underlying assets being made available to investors in order for them to make informed decisions about the likely credit performance and therefore cash-flows from a pool. The level of detail required in this respect will vary between asset pools. It should not be assumed though that, as a general rule, investors should have sufficient information to re-underwrite all the assets in every pool. This is typically not the core skill of an ABS investor and, in granular pools of homogenous assets, is not necessary. There is also the potential risk that unnecessary levels of data provided may actually act as disincentive for new investors by adding complexity – further diminishing the purpose of having a big, meaningful, picture on the underlying assets.

In more concentrated or less homogeneous pools (such as SME CLOs or large-loan CMBS) it is more important to look at individual loan characteristics. However, while most investors probably do not want and are not expected to re-underwrite the pool, there should be both sufficient qualitative information available on the borrowers to give investors a good guide to the quality of the pool (such as length of time established, time with bank, historic default performance, security details, underwriting lease / tenant information, credit score etc.) and quantitative data of sufficiently high quality and detail to ensure as robust modelling as individual investors require. It should be noted that with assets such as these, a key part of the credit decision is gaining comfort with the underwriting, servicing and risk and control processes of the originator.

We would be very pleased to see the development of centralised credit bureaux in every jurisdiction with both positive and negative information shared on a standard basis between all lenders. With this in place, originators would be more able to supply the details that investors require on securitised pools.

We do not think that direct access to such bureaux by ABS investors would be practical or should be necessary.

12. In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for securitisations?

There is a large amount of macro-economic data already available and we do not feel that ABS issuers should be required to publish anything along these lines. We would happily discuss this further though, as we are not sure we fully understand the proposal.

The challenges of providing loan level data are largely being addressed. Processes around the EDW are continuing to be absorbed by the market and it will take some time for all the issues to be ironed out, originators to develop systems to more easily comply and investors to make full use of the data but we seem to be moving in the right direction – particularly for the more prevalent asset types (RMBS, autos etc.). We mention a few suggestions around SMEs above.

As an additional element of transparency, we would advocate that data underlying ratings decisions should be disclosed to investors. This would allow a greater ability to challenge any perceived mis-ratings – both by investors and regulators.

Whilst disclosure to investors is improving, agencies are frequently given access to additional information that would aid investors. Whilst truly proprietary information must be kept confidential, we would recommend all other information received by the ratings agencies during the ratings process be disclosed.

Ideally, the industry would move to standardised disclosure for each type of collateral for the initial pool of assets, and issuers and/or servicers would update information regarding the performance of the assets in the pool over the life of the transaction to facilitate ongoing surveillance of the securities.

This enhanced transparency would allow investors to review the data underlying ratings opinions, allowing better insight into a rating agency's process and the accuracy of its data analysis. This provision will also facilitate regulatory oversight and incentivise a more robust and objective credit rating process.

However, whilst data is necessary it is not sufficient. Qualitative information should also be provided to investors such as on the banks' criteria and underwriting processes.

13. Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be most useful and which could be easily produced?

No comment

Enhanced transparency of credit ratings

14. Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

Post-closing, we agree that it would be very useful for rating actions to disclose the combined impact of sovereign / counterparty rating caps applied to a credit rating so that the underlying credit can be separated from the ratings impact of the associated links. We should note though, that the press release accompanying most actions specifies the rationale for the action allowing investors some ability to differentiate the ratings. However, we would certainly support the additional disclosure of the combined impact in a matrix form; indeed, we have suggested something similar to the agencies ourselves.

When a new rating is assigned, the issue is slightly less clear. What we have observed in recent deals is that the underlying transactions have been structured to the ratings cap. Therefore the rating should the cap be removed would be no different.

For example:

- A €500m asset pool (taking no account of Sovereign cap) requires 20% credit enhancement for a AAA rating and 15% credit enhancement for a AA rating.
- The Sovereign cap is set at AA.
- The originator has two options:
    - sell €400m AA bonds with 20% credit enhancement or

- sell €425m AA bonds with 16% credit enhancement

Given that the market is highly unlikely to differentiate (or in any case materially differentiate) in terms of pricing, the rational originator structures with 16% credit enhancement and sells more bonds against the same portfolio. Therefore the Sovereign cap has impacted the structuring approach rather than simply capping what would otherwise have been a more highly rated bond.

We are not suggesting that this is the case in all transaction but it does seem to be something we are seeing.

Design of ancillary facilities

15. How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

Bank accounts feature in two areas of consideration in structured finance transactions. The first is ratings linkage and the second is commingling risk (where funds are held with other non-securitised cash flows e.g. in a collection account prior to being transferred into an account in the name of the issuer SPV).

In respect of ratings linkage, we feel that an investigation of the possibility of securitisation vehicles accessing bank accounts that fall outside the account provider's insolvency estate and so are fully protected in the event of the provider's default would be a positive move. We understand that there have been some regulatory developments in this regard in France although at the moment there is no ratings benefit for the construct which rather limits the usefulness since one of the main problems in respect of bank account providers is the limited number of sufficiently highly rated counterparties.

On the commingling side, one of the main reasons given for not having borrowers pay directly into the account of the SPV is that the account for a direct debit mandate cannot be changed without the consent of the borrower. In UK transactions, borrowers' direct debit mandates can be directed into a separate account (still in the name of the originator) held on trust which avoids funds being tied up in the bankruptcy estate. However until funds are transferred to the accounts of the SPV this is still accounted for as commingling risk in the ratings agencies' criteria. Originators, quite reasonably, want to avoid notifying borrowers that their accounts have been sold in case there is an impact on the relationship, there is also an operational risk in getting borrowers to sign new mandates in that it could disrupt payments. In Sweden (and possibly Portugal) it is possible to re-direct a direct debit mandate without having to notify the borrower. Having this ability in other jurisdictions would materially reduce commingling risk –something that can require separate reserves within a deal - and therefore release originators' funds.

<u>Broader questions:</u>

16. With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?

We welcome granular data disclosure where this provides transparency in a way that is useful to investors. As such, we recommend establishing a platform where investors can access easily and quickly the specific information they need. The disclosure system needs to be “user-friendly” to be valuable for investors.

17. Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets? Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?

No comment

July 17, 2014

Bank of England: Securitisation2014@bankofengland.co.uk
European Central Bank: Securitisation2014@ecb.europa.eu

RE: Reponses to "The Case for a Better Functioning Securitisation Market in the European Union"

To Whom It May Concern:

Bloomberg L.P. (Bloomberg) welcomes the opportunity to submit comments in response to the Bank of England (BOE) and European Central Bank (ECB) paper: **The Case for a Better Functioning Securitisation Market in the European Union**. Bloomberg enthusiastically agrees that the structured finance markets can only benefit from the maximum amount of transparency available. If the goal of this discussion paper is to assure that the data and analytics, which are materially relied upon by those making investment decisions, factually and accurately represent the actual values of the assets at the loan level and the waterfall structure in every asset-backed securities (ABS) deal at all times, then Bloomberg believes that requiring issuers to file reliable, accurate, and timely loan-level data which can be utilized by a waterfall computer program for all ABS deals is essential to making that goal a reality. We believe this will facilitate the promotion of securitisations in which the risks and the payoffs are consistently and predictably understood.

A. Company Overview.

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The BLOOMBERG PROFESSIONAL® service delivers analytics and data on approximately five million financial instruments spanning all major asset classes and currencies (including all varieties of mortgage-related securities), as well as news on almost every publicly traded company, to more than 320,000 professionals in the business and financial community around the world. Many major central banks as well as investment institutions, commercial banks, government agencies, and money managers with a regional or global presence are users of the BLOOMBERG PROFESSIONAL® service, giving Bloomberg an extraordinary view of the global markets

B. Transparency Will Reduce Panic in Times of Stress.

The global financial crisis was exacerbated by a lack of transparency in the RMBS market. This uncertainty was created because investors were uncertain how RMBS waterfall structures would perform under duress. The inability to view a single market-wide waterfall model in a common open source language greatly contributed to the liquidity crisis because investors could not determine with assurance the ongoing cash flows of the RMBS bonds. As a result, it became increasingly difficult to properly price these securities and that difficulty led to panic selling. Requiring improved disclosure of and decreasing the flaws in loan-level data will provide investors and the market with the certainty of knowing what their RMBS cash flows will be during any market event.

Only the ECB and BOE can ensure that the loan-level data that is materially relied upon to make investment decisions factually represents the underlying assets of any ABS and that it can be used to evaluate risk at the predictive level and the cash flow level. When this occurs, regulators, investors, and the market will have a complete picture of how future cash flows will impact the value of market of value of ABS prices in all types of market conditions. We support any endeavor by the ECB and/or BOE that further this goal.

C. Bloomberg's Contribution to a Better Functioning Securitisation Market.

Bloomberg agrees with the BOE and ECB that the ABS markets will benefit from the maximum amount of transparency available. To that end, in 2013, at no extra cost to our BLOOMBERG PROFESSIONAL® service users, Bloomberg funded an initiative to bring two enhancements to RMBS deal disclosure aimed at bringing greater transparency to the market. These enhancements were implemented at the asset-level and at the liability, bond, and waterfall levels.

The asset-level enhancements we implemented include, but are not limited to, the disclosure of anonymous loan level data, the ability to analyze the layered risk of loan level collateral, customized performance and surveillance screens powered by loan level collateral information, the ability to perform and share custom stratification and groupings and the ability to create and share current and historic surveillance sheets powered by dynamic customized calculations. We have also partnered with the European DataWarehouse (ED) to source and redistribute the EDW loan level data for all supported ABS asset classes.

The waterfall enhancements we implemented allow any ABS deal to be modeled in the Python programming language. This functionality provides a dynamic transparency tool that investors can use to view or modify any deal feature. It also offers investors a new type of structuring tool for new issuances in the Python Open Source Waterfall. Importantly, this enhancement provides investors, trustees, issuers and other market participants with the ability to create, view, modify, and stress all deal attributes including deal triggers, and the ability to view and modify existing waterfalls and conduct "what if" substitutions of loan level assets.

D. Bloomberg Responses to BOE/ECB Questions.

We have chosen to respond only to those questions which we think we have the required expertise necessary to add value to this discussion. As a result, we have replicated the relevant questions in Section 5 and set forth our responses to them below.

1. Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?

RESPONSE: Yes. We agree that a well-functioning and transparent securitisation market provides benefits to issuers, investors, and the real economy at large.

2. Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?

RESPONSE: We agree that providing standardized loan-level data has been a challenge for a number of issuers. In some cases, our experience was that the information was not available or that systems needed to be modified to be able to cope with the request for such data. In our view, most of the institutions seem to have overcome the initial challenge of making this data available. Bloomberg has been and remains committed to providing technology to issuers to make this data more readily available. Bloomberg pays a fee to the ED to source data for ABS transactions and we re-distribute that data to permissioned members of the ED who access our services. But we have noticed that flaws exist in the quality of the loan-level data being reported which makes the modeling of future cash flows in ABS deals more difficult. Our view is that clean, granular, standardized loan-level information for ABS deals is extremely important for risk management purposes, and ultimately, the revival of a robust securitisation market.

3. Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

RESPONSE: Based on our interaction with existing market participants, we believe that market liquidity is a concern for investors, but it is not the only concern. The regulatory treatment of securitisations, specifically capital and risk-weighting requirements, also seem to be an important barrier to a well-functioning securitisation market. Bloomberg is currently working with various market participants to explore ways to increase liquidity in the European ABS markets. We would be happy to discuss these efforts with you.

4. The view of the Bank of England and the ECB is that a ‘qualifying securitisation’ should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a ‘qualifying securitisation’ not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

RESPONSE: We generally agree with the principles surrounding the term “qualifying securitisation” set forth in the discussion paper. However, for loan-level data to be truly useful to the market, we would stress that its timely release is critical. In particular, we would suggest that data should be released no later than the second (2nd) business day after the interest payment date (IPD). Investors use loan-level data to validate investor reports, and to integrate this information into their prepayment, credit, and pricing models to evaluate risk, which is precisely why having current data is of significant importance.

We also believe that a key to making securitisations simpler, transparent, and more robust so that investors can model and understand with confidence the risks involved in ABS securities would be to harmonize the definitions that relate to the data used in investor reports across the EU as well as with the UK. For example, it would be immensely useful for current and potential investors to have a single definition of what it means for a borrower to be in default.

5. Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted?

<u>RESPONSE</u>: Yes, we agree that that harmonisation and further conversion software could bring benefits to securitisation markets. We believe that the RMBS, SME and Auto asset classes should be targeted.

6. How can accessibility to the existing loan level data be improved, so that it provides most value to investors?

<u>RESPONSE</u>: The loan-level data file provided to ED should be the same file that is used by the Trustee to create the investor report. In our experience, reconciliation of the loan-level data file to the investor report is difficult to undertake for many deals. For example, we have found that in certain instances the files are cut-off on different dates, and in other instances, they simply don’t reconcile at all.

The release of the loan-level data file on the Trustee website is so delayed that it does not provide any real value to investors. Currently, this information is published no later than one (1) month after the IPD. As stated above, our view is that loan-level data file should be available no later than the second (2nd) business day after the IPD. One must ask, if the investor report is provided by the IPD, why is the loan-level data file also not made available at that time? In the U.S., the majority of RMBS deals make loan-level data files available within a few days of the IPD. We have observed that much of the user activity on our system happens within a week of the updated investor report. As long as the reporting of loan-level data is substantially delayed in comparison to the investor reports, Bloomberg will continue to allow investors to use pool-level data to project cash flows and drive our models. Using pool-level (i.e. aggregate level) loan data is not as accurate loan-level data and thus, the cash flow models are not as precise as they could be.

We also have some process recommendations. We believe that (1) an automated e-mail notification of loan-level file and investor report availability would be much more efficient than requiring an investor to check the Trustee website for updates (this inefficiency can also be corrected if all of this information was available through a single portal as the discussion paper suggest); (2) all files should be labeled by the Trustee with the IPD date (currently some label files with the month uploaded and others with the pay date); and (3) scoring of the EDW data should take into account the validity of fields, and the availability of required fields. (i.e. two deals can both be scored A1, yet one deal can be amortized and tied out to the investor report, and in the other, the loans won't amortize to zero with the current characteristics and nothing ties out to the investor report).

Along these lines we believe that there are optional fields in the ED RMBS Format that should be considered for mandatory status. One set of fields is important for Credit/Prepay Models and Cash Flow Risk Classifications, the other is important for Cash Flows, Advance Estimates, Modification, and Restructure Detection.

1. Credit/Prepay Models and Cash Flow Risk Classifications

- *Lien Position*-- This is an optional field that is rarely provided, but default and severity risk is typically much higher on second (2^{nd}) liens than first (1^{st}).
- *Occupancy Type*-- Owner occupied properties tend to default at a slower pace than loan on investor-owned or vacation residences.
- *Debt-To-Income*-- DTI ration is heavily relied upon during the loan origination as well as any modification process in order to verify a borrower's ability to repay. DTI should be mandatory for all loans at origination, and it should be updated at least annually.
- *Combined Loan-To-Value (CLTV)*-- We believe that this metric is a strong indicator of default because when you analyze the value of the 1^{st} lien it forces you to consider the 2^{nd} lien and its value. The CLTV is one of the stronger default indicators used in U.S. ABS deals and it drives many of the credit, prepayment, and severity models.
- *Region/Postal Code*—Although this is a required data field, with only two data bytes of the postal code it is currently not possible to map this to a specific province or state in many cases. We believe that three data bytes should be required or in the alternative, we would recommend requiring the reporting of the optional geographic region field. Ideally, it should be possible for an investor to match a property value index or AVM on a province by province or state by state basis so that a meaningful current LTV figure cane be derived and used in a consistent manner across the entirety of the European RMBS universe. Today, the originator can choose their preferred method to determine a current valuation amount, which means when comparing the LTV of like securities' investors may be comparing apples to oranges. While we understand that certain privacy barriers may exist, we urge the ECB/BOE not to anonymize this data in such a way that it becomes useless.

2. Important for Cash Flows, Advance Estimates, Modification or Restructure Detection

- *Further Advance/Maximum Balance*-- For loans with redraw or further advance capabilities, populating these fields should be required. Even if the further advance field is broken out into a different loan id, it will be useful to investors and further improve the accuracy of the cash flow models they use.
- *Principal Grace Period/IO Term* - For Interest Only loans this is an important field because it helps to validate that a loan can be amortized properly, and it should produce accurate cash flows.

- *Cumulative Prepays/Curtailments* - Since there a full loan history for most deals does not exist, requiring the Trustee to populate a cumulative prepay filed will allow investors to understand how far off schedule the loan is. Additionally, accurate prepayment interest shortfall amounts cannot be calculated without this.
- *Additional Collateral Value/ISAs* - The account balance used to secure the loan can be an important determinant that can help investors understand whether any amortization issues may surface. This could also prove very helpful in the calculation of severity models.

7. Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardized investor reports in a single location be helpful to securitisation markets?

RESPONSE: Authorities could do more to facilitate transparency by requiring the publication of documentation for both "qualifying securitisations" and non-qualifying securitizations. More important, the ECB/BOE should push to standardize ABS documentation across the EU and among the EU and the UK. This move towards standardization should include all deal documents, investor reports, prospectuses, and supporting documentation. When investors and market participants can follow a common template, it makes the structure, the assets, and the pricing of ABS deals much simpler to read, analyze, and price.

8. Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets?

RESPONSE: We agree with this statement.

9. Would credit registers be helpful in this respect?

RESPONSE: Yes, but we also understand the operational issues that arise during the implementation of a new system of this scope.

10. If so, which asset classes should be targeted?

RESPONSE: We believe that the RMBS asset class should be targeted initially.

11. In what form could access be granted to ensure that borrowers' confidentiality is preserved?

RESPONSE: With numerous cross-border differences in privacy laws, this task must be carefully managed. Although there is no unified credit score across Europe today, such as FICO in the U.S., it may be prudent to devise a standardized credit metric that takes into account individual privacy. Again, we understand the delicate balance between masking the information while also making sure it's useful to investors. One way to achieve this could be to require a credit grade assessment that an investor can easily map to a pre-determined credit tier. Many originators currently have their own credit scoring systems that could be mapped to a standardized credit grade. We believe that most originators should be able to map there internal scoring mechanism to a standardized credit grade bucket. In lieu of this, understanding the total outstanding Borrower Debt at Origination is essential. While a borrower's LTV and income help to categorize the credit risk, they are not a complete picture if the borrower's total debt and utilization of other trade lines are unknown. We recommend making the "Class of Borrower" field mandatory. Again, if the purpose of this discussion draft is to obtain ideas to make securitisations simpler, more structurally robust and transparent in order to enable investors to model and understand the risks they are incurring with confidence, then a standardized credit evaluation system must be put in place across the EU.

12. In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

RESPONSE: A lack of historical loan-level data makes it hard to validate historical transactions against the data provided in the new ABS deal prospectus. This also makes it very difficult to build meaningful assumptions about future loan collateral performance. It is hard to build a credit or a prepay model without sufficient loan performance history. Most investors prefer at least five years of data before they will even consider trying to build a meaningful credit model. The timely posting of data, more historical loan-level data, and increased disclosure of other borrower debt would go a long way to being able to project future bond performance.

Please let us know if we can provide any further information on this issue.

Sincerely,

/s/ Russel Parentela

Global Head of Structured Products

Bloomberg L.P.

BritishBusinessBank
Unlocking finance for smaller businesses

British Business Bank response to Bank of England securitisation discussion paper

We welcome the opportunity to respond to the Bank of England's discussion paper 'The case for a better functioning securitisation market in the European Union', following on from our recent meeting with BoE.

About the British Business Bank

The goal of the British Business Bank is to change the structure of finance markets so that they work more effectively and dynamically for smaller businesses, allowing them to prosper and build economic activity and additional jobs in the UK. To deliver this, the Business Bank has set four objectives:

- To increase the supply of finance available to SMEs in areas where markets do not work well
- To help create a more diverse market for SME finance with greater choice of options and providers
- To promote better information in the market, building confidence among SMEs in their understanding of the finance options available
- Whilst achieving the above, the Bank will manage taxpayer resources efficiently

The Business Bank will achieve these objectives by:

- Bringing together expertise and Government money to the smaller business finance markets
- Understanding markets and smaller businesses' finance needs and using this to design programmes to make markets work better
- Investing alongside private sector investors to maximise our impact, allowing us to reach the full range of finance providers

We are an evidence-based organisation, and assign considerable resources to data gathering and analysis to properly inform our programmes and resource allocation.

Understanding the market

The Business Bank's understanding of the market is obtained through a combination of formal research, drawing on the research of others, and through 'soft' intelligence gained from direct engagement with other actors in the market, and underpins the products that we develop. Each firm has a variety of potential options for the type of finance it obtains and where it obtains this finance from. The type of finance which is most appropriate for a firm will depend on a number of factors, and this is reflected in the design of the Business Bank products.

A well-functioning, high quality securitisation market, and in particular effective securitisation of SME liabilities, is an important part of the landscape that is needed to secure better access to finance for smaller companies. We therefore support the strengthening and revitalisation of the market, whilst being fully cognisant of the potential impact of financial stability. <u>We welcome BoE's commitment to explore the best way to approach this goal, and support the principles of the policy levers that have been suggested.</u>

A number of imperfections affect the business finance markets for SMEs. In particular asymmetric information and market concentration lead to the so-called equity gap, and gaps in the provision of debt finance to SMEs. There are two key problems in the market where a well-functioning SME securitisation market will be beneficial:

Market concentration: High quality SME Securitisation has the potential to support greater competition and choice in SME lending through access to more attractive funding sources for smaller banks and asset finance providers.

The market is highly concentrated with the top 4 banks having over 80% of the lending market. SMEs are highly dependent on bank finance to meet their financing needs. This means that when the financial crisis happened and banks were forced to pull out SMEs were left with few alternative forms of finance.

A well-functioning SME lending market should include a variety of lenders all competing to offer good quality products to suit the financing needs of businesses. This will create greater choice and capacity in the market, and will lead to greater competition with decreasing margins for SMEs.

At the moment there are high barriers to entry in the SME lending market, smaller lenders and asset providers are unable to access adequate sources of wholesale funding. High quality SME Securitisation could potentially offer a more efficient form of funding and allow greater diversification of funding sources for them to expand their SME lending.

Market capacity: High quality SME securitisation can create lending capacity in the market by reducing some of the capital requirements arising from regulatory changes.

Smaller business lending is particularly capital intensive, and hence less profitable for banks compared to other types of lending. In the current climate, banks are likely to be capital-constrained due to post-crisis deleveraging and increasing international capital requirements. This is likely to increase further in the future due to the phased Basel III introduction, meaning banks are less likely to allocate capital to smaller business lending. A capital constraint also affects the supply of long-term debt finance products, which is particularly relevant to established businesses looking to grow.

Business Bank Activity

The Business Bank is active in a number of areas that are relevant to the BoE's paper, and hope to use the experience and knowledge that we are gaining from this activity to support the Bank to take forward its work on securitisation markets over the coming months.

As well as specific products that rely on securitisation (see below) The Business Bank will shortly be conducting some research to deepen our knowledge of the UK securitisation market, including its interaction with its regulatory framework. We welcome the opportunity to work with the Bank of England as we take this work forward.

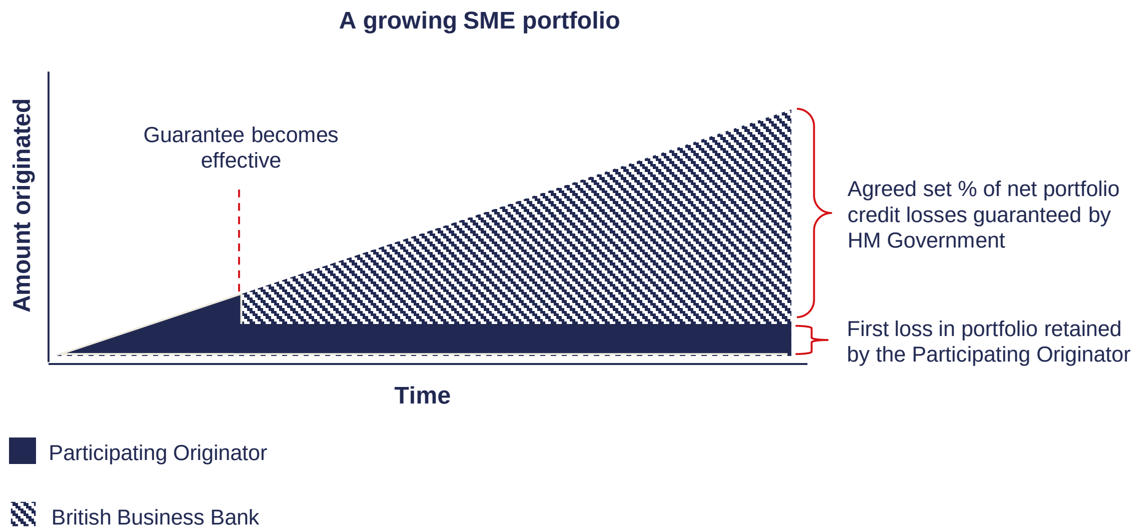
An important Business Bank programme using securitisation techniques is our wholesale solutions initiative. Engaging with the BoE as we take this forward provides a potential vehicle to explore securitisation policy options within the market setting.

Wholesale Guarantees

This product aims to address the relatively high capital requirements which are required for SME lending, so making SME lending more attractive to banks. The objective is to encourage the banks to direct more capital towards SME lending, and especially to encourage smaller 'Standardised' banks into the market. The programme will share a portion of the underlying second loss risk on portfolios of newly originated loans, transferring part of the credit risk to BIS without exposing it to an undue level of risk. A request for proposals to pilot the first stage was released in March 2014, with first transactions expected to be structured in summer 2014.

This is a potentially flexible tool which can be designed to tackle different segments of smaller business lending. The evaluation of the pilot programme will be an important source of data, and could potentially help to collect some of the information that is required to shape requirements for possible 'qualifying securitisations.' We welcome the BoE's engagement with us to help shape our evaluation accordingly. **Figure 1** (below) illustrates the principle of how the wholesale guarantee will operate.

Figure 1.



Asset Finance Funding vehicle

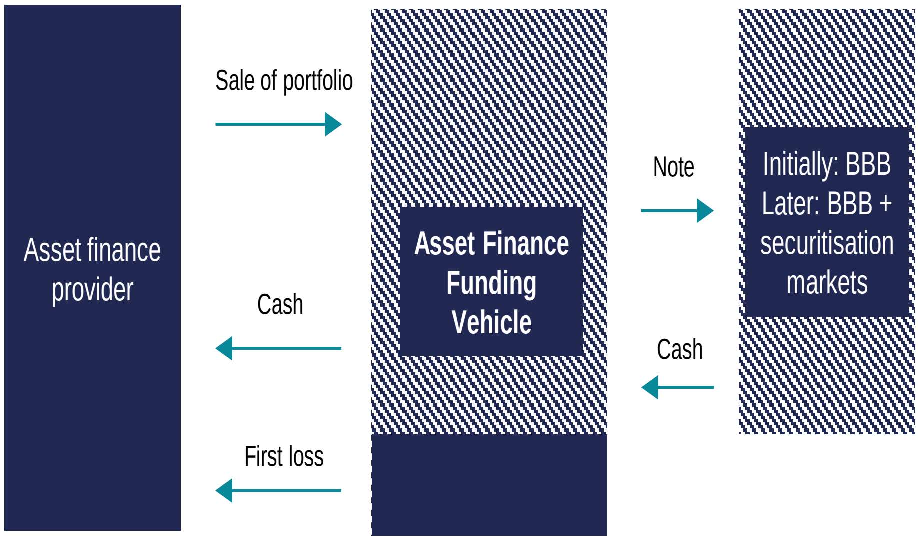
The British Business Bank and the European Investment Fund will facilitate the establishment of an Asset Finance Funding Vehicle (the 'AFFV'), which is currently in its design stage. The AFFV will be a special purpose vehicle aiming to provide liquidity to smaller asset finance providers which currently struggle to obtain funds at a cost-effective price. In turn, these providers will use AFFV's funds to continue supporting small businesses seeking to finance their assets.

The AFFV will aim to level the playing field between the small and the large asset financiers by purchasing smaller asset finance portfolios and thus giving the smaller players access to efficient funding. Initially AFFV's resources will be provided by BIS and the EIF, but once it accumulates a critical mass of asset finance receivables it will start drawing the majority of its funds from the capital markets by issuing asset backed securities.

This will tackle coordination failures that exist where small finance providers lack the scale to access capital markets alone and where there may be limited scope for private agents to act as an aggregator due to their inability to capture wider spill-over benefits. Additionally, the competitive nature of firms may be such that without a public body confirming the type of loans in a securitisation, the market will always be vulnerable to Gresham's Law (where banks may be tempted to substitute low quality loans into an asset pool, and just the risk that this might happen can undermine a market, demonstrated by Pagano and Volpin in 2012).

The AFFV will be structured such that the British Business Bank, the EIF and later the private sector investors are not exposed to undue risks. Every asset financier participating in this scheme will be required to retain a significant first loss position in the portfolio sold to the AFFV. In addition, only receivables of sufficient credit quality will be eligible for sale into the vehicle, and the British Business Bank together with the EIF will closely monitor compliance with these standards. **Figure 2** (below) illustrates the principle of how AFFVs will operate.

Figure 2.



The case for a better functioning securitisation market in the European Union – a BPF response

BPF
BRITISH PROPERTY FEDERATION

Introduction

The British Property Federation (BPF) is the voice of property in the UK, representing businesses owning, managing and investing in property. This includes a broad range of businesses comprising property developers and owners, financial institutions, corporate and local private landlords and those professions that support the industry.

We welcome the opportunity to comment on the Bank of England/European Central Bank Discussion Paper on ways to improve the way that securitisation works in Europe.

General comments

The commercial real estate (CRE) sector is an important and significant part of the UK economy, with a capital value of £650bn[1] and a GVA of approximately 3% of the UK total.[2] Most of the economic activity in CRE involves the construction, development and management of buildings and employs nearly 900,000 people.[3] Moreover, by providing businesses with the physical infrastructure in which to carry out its activities, CRE is a critical enabler of economic growth and competitiveness more generally.

As a capital intensive business involving occasionally very large and valuable assets, CRE is dependent on the ready availability of debt finance. This is especially the case in economically more marginal places where – despite there often being a very real demand – institutional equity capital can be disinclined to invest due to the lack of opportunities for investment at scale or a lack of familiarity with the area.

The UK CRE industry has historically sourced the significant majority of its debt finance from the banking sector. Indeed, during the last CRE boom the bulk of that finance was procured from a relatively small number of systemically important banking institutions. When the CRE market went into sharp decline, those institutions suffered significant losses on their loans to the sector, which contributed to their inability to carry out new lending at the trough of the CRE cycle – just when that lending was most urgently needed. CRE lending by banks has since picked up again, but the industry's reliance on bank funding was very clearly exposed and the need for a more diversified and more resilient CRE finance market was brought into sharp relief.

This diversification has begun to take place in the UK, with non-bank institutions such as pension funds and insurance companies dipping their toes into CRE lending. Specialist CRE debt funds have also emerged, often willing to provide debt finance to CRE deals at the small-medium end of the spectrum. We very much welcome these developments and hope that they will continue to progress. In our view the existence of CRE lenders with different business plans and investment horizons is conducive to both greater financial stability and a better availability of debt finance that

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[1] *The Size and Structure of the UK Property Market 2013 – A Decade of Change* – Investment Property Forum
[2] *Property Data Report 2013* – Property Industry Alliance
[3] *Ibid*

is (relatively) blind to the CRE cycle, mitigating to some extent the damaging effects of CRE booms and busts.

The role of securitisation in CRE

UK CMBS attracted significant negative publicity during the latest CRE crash. Reports circulated of instances of losses to investors as a result of the poor quality of underlying loan portfolios and of conflicts between different classes of bondholders.

Yet CMBS losses did not primarily arise because securitisation is somehow inherently inappropriate for CRE loans, nor did they occur as a result of the CMBS structures in use at the time (although some could certainly have been better). Instead, the principal reason for losses on CMBS was a standard of CRE loan underwriting that had in some instances arguably become cavalier. The fact that CMBS investors faced losses simply reflected what happened in the wider CRE debt market.

In our view, CMBS is an integral part of the more diversified and resilient CRE finance market that we would like to see emerge over the next few years. As identified in the Discussion Paper, securitisation (including CMBS) offers a tool for banks to diversify their funding sources and for non-bank institutions to gain access to an investment exposure which might otherwise be out of their reach. We entirely agree with these goals and would support any initiatives that facilitate them.

However, in order for CMBS to flourish and be a useful source of CRE debt finance its regulatory treatment must be proportionate. That has not been the case in recent history, with for instance Solvency II requiring far higher capital requirements where insurers hold highly-rated CMBS than where they hold CRE directly. Such an approach seems designed to 'punish' CMBS – presumably for its poor investment performance during the financial crisis – rather than being based on the underlying investment characteristics of CMBS, which if designed correctly can be a highly secure and stable investment.

Some comments on 'qualifying securitisations'

We therefore welcome the Discussion Paper's principles-based approach to identifying potentially 'qualifying' securitisations. In particular, we agree that such status should be attributed to securitisations where *"their simplicity, structural robustness and transparency enable investors to model risk with confidence"*. We see no reason why CMBS should in principle be incapable of satisfying these criteria.

We also agree that qualifying status should not attempt to *"provide an opinion on credit or other risks, but make assessment of these risks more straightforward"*. Ultimately, as long as an investor is able to gauge the level of risk involved with a particular investment and get comfortable with it, it should be of little consequence that the investment is potentially a volatile and unpredictable one.

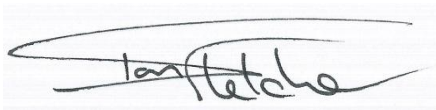
Unfortunately, there are some features of a qualifying securitisation identified in the Discussion Paper that do appear to take credit and other risks into account. In particular, paragraph 132 seems to suggest that refinancing risk cannot be accurately measured and therefore loans which do not fully amortise cannot form part of a qualifying securitisation.

Such an approach would effectively preclude most CMBS from qualifying status, as CRE lending is very rarely fully amortising (this can only happen where very long leases are in place). That in turn would minimise the appeal of CMBS to investors, lenders and borrowers and prevent CMBS from playing the important role we believe it should in a diverse CRE finance market. In any case, given adequate information it is in fact generally possible to assess refinancing risk, so CMBS should not be denied qualifying status merely because the underlying loans are not self-liquidating. Furthermore, certain structural features (e.g. long tail-periods between loan and bond maturity) can be incorporated into CMBS structures to further mitigate the risk of failed refinancing.

For further detail on this point and for detailed responses to the questions in the Discussion Paper we would refer you to the response of **CREFC Europe**, which we have reviewed and keenly support.

In summary, we think CMBS has a key role to play in the future of CRE lending. It would be disappointing for the CRE industry and indeed for the economy as a whole if unnecessarily punitive regulatory constraints prevented this from taking place.

We remain at your disposal should you wish to discuss the above or any of the points raised in the Discussion Paper.



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BANK OF ENGLAND / ECB DP ON SECURITISATION

RESPONSE FROM THE BUILDING SOCIETIES ASSOCIATION

Introduction

The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 44 UK building societies. Building societies have total assets of nearly £330 billion and, together with their subsidiaries, hold residential mortgages of over £230 billion, 18% of the total outstanding in the UK. They hold over £230 billion of retail deposits, accounting for 19% of all such deposits in the UK.

The BSA welcomes the joint initiative by the Bank and the ECB, begun with the brief paper published on 11th April and developed in the end-May Discussion Paper (DP), to "make the case" for a better functioning securitisation market in the EU.

In this high-level response we concentrate on matters relevant to our members' experience, and potential future activity, as originators and occasional investors. We agree with the broad summary of the benefits of securitisation in section 2, and it is helpful to have these officially re-stated.

General comments

The core business of all BSA members lies within traditional relationship banking: personal savings and mortgage lending. BSA members are not investment banks and do not structure complex transactions for others. Moreover, building societies are obliged by law to concentrate on retail savings and residential mortgages. Consistent with the relationship approach, BSA members primarily follow the "originate to hold" rather than "originate to distribute" model. We fully recognize the problems that have arisen during the financial crisis from unwise and irresponsible use of securitisation by others. But some of our largest members continue to make prudent and measured use of securitisation as originators, for risk transfer and capital relief, and /or for longer-term matched funding, and some may also invest in RMBS from time to time. The BSA therefore has an interest in maintaining an active, liquid and cost-effective market for securitisation.

Our first concern, consistent with our members' prudent use of securitisation, is that the technique should not continue to be broadly stigmatized, *inter alia* through onerous capital treatment, by way of over-reaction to the admittedly unwise activities by other players before the financial crisis. Where undesirable behaviours are identified, regulation should target these more closely, without overall stigmatisation of securitisation as a financing technique.

We therefore welcome the recognition in the April paper and the following DP that some of the obstacles to securitisation are regulatory in origin, indeed that some of the post-crisis proposals may have been counterproductive. And we generally support the concept of "qualifying securitisations" for the labelling of those *transactions* that are simple, structurally robust and transparent. We agree – as proposed in the DP – that such labelling should in principle cover the whole transaction – all tranches – and not be limited to the most senior tranche only.

We note that the industry had already taken steps towards setting quality standards through the establishment of the Prime Collateralised Securities initiative and label in 2012. The PCS initiative and label, suitably developed and regulated, could perhaps form the basis for certifying "qualifying securitisations" – so avoiding duplication and confusion, and (it is hoped) minimising costs to the industry.

A particular concern for our medium-sized and smaller members is that the qualifying securitisation criteria should not discriminate against multi-originator pooled RMBS issues. Single-originator issues may not be economical for those societies, as each may have insufficient assets available to justify a solo issue bearing in mind the upfront costs and other fixed overheads. Discrimination against pooled issuance would be anti-competitive, favouring large incumbent firms.

Specific responses

We broadly agree with the summary of the benefits of securitisation in section 2 of the DP. For BSA members, the principal benefits will be as a funding tool and in some cases also as a risk transfer mechanism bringing capital relief.

We agree that paragraphs 63 to 95 cover the key impediments from an issuer / originator perspective. The greatest impediments to those BSA members that have **not** so far used securitisation are probably *asset availability* (paragraph 85); and *systems and credibility* (paragraph 88). We also identify, as a composite impediment, the question of *scale* and the extra complexity of multi-originator RMBS mentioned above. Many medium-sized building societies generate sufficient suitable mortgage assets to contribute to a pooled RMBS involving, say, five originating societies which spreads the fixed costs over a sufficiently large total pool to make the transaction economic, where none of the participating societies could economically undertake a solo transaction as their available asset pool is too small.

The *regulatory impediment* operates both directly and indirectly. Some of the proposals in the Basel securitisation review were, as the DP politely admits, "unduly conservative", and will have had a direct effect in discouraging securitisation e.g. by making transactions uneconomic from the capital relief perspective. The indirect regulatory effects include the current uncertainty, pending finalisation and implementation in the EU of whatever results from the Basel review, and (more generally) the hostile and stigmatising rhetoric that has sometimes accompanied these regulatory proposals. We doubt, in the absence of more favourable regulatory treatment for qualifying securitisations, whether such labelling on its own will achieve the desired step change towards a better functioning securitisation market. The case for more favourable treatment is supported by the conclusions of the empirical study[1] by Perraudin / Risk Control Ltd, commissioned by the PCS.

Two lesser impediments fall under the heading of design of ancillary facilities, as mentioned in the DP at paragraphs 118- 123. First, the penal swap counterparty criteria introduced by the ratings agencies post-crisis, and the requirement for "volatility buffers" (effectively collateral add-ons). Second, the problem of SPV bank accounts, and whether these could be made insolvency remote – we think this would be (net) beneficial, though difficult to achieve without, for instance, some central bank involvement.

Turning to the high level principles, these appear broadly sensible. We have two specific comments relevant to our members' potential future issuance of RMBS. First, we query the

[1] http://pcsmarket.org/wp-content/uploads/2014/06/empirical-study-of-high-quality-securitisation.pdf

practical impact of the criterion on ***perfection of interest***. As stated, this appears to require the perfection of the issuer's title to each mortgage by registration of the transfer from the seller with notice to the underlying borrowers. We understand this has not been customary in UK RMBS, rather the initial sale takes effect in English law as an equitable transfer, and the issuer has the ability to effect registration at any time, thereby perfecting its legal title, without further involving the seller at that stage. A move to full registered legal transfer at the point of original sale would be a major departure from current practice (which has not proved problematic in the UK and arguably does not need to be changed).

Second, we suggest that - for the avoidance of doubt – the principles should include an explicit statement to the effect that multi-originator securitisations may qualify, notwithstanding the slight increase in structural complexity.

Those of our members with extensive securitisation experience may wish to respond in more detail to the technical questions in the DP.

BSA July 2014

BDI/DAI/VDT: Proposed securitisation market regulations will impair the refinancing of the German real economy

The German securitisation market plays a pivotal role especially with regard to sales and working capital financing in the German industry. Bundesverband der Deutschen Industrie (BDI)[1], Deutsches Aktieninstitut (DAI)[2] and Verband Deutscher Treasurer (VDT)[3] are very concerned that upcoming legislations will impair this market and will decrease capabilities of German corporates to use securitisation for financing purposes.

In particular we want to draw your attention on the following rules which we assume as highly problematic:

1) New liquidity rules / liquidity coverage ratio (CRR, Art 424 et seq.)

On the basis of a BCBS proposal dating from January 2013 on the structure of the liquidity coverage ratio (LCR), in February 2013 the EBA published a discussion paper on the definition of liquid assets and in October 2013 conducted a public consultation. As far as we are aware, auto ABS would not represent "liquid assets" within the meaning of the LCR, in contrast to government bonds, covered bonds and (with high haircuts) corporate bonds.

In addition, the securitisation of trade and leasing receivables would also be affected. The LCR compels banks that operate platforms for the securitisation of trade and leasing receivables to set aside liquid assets for their obligations arising from the liquidity cover requirements in ABCP programmes. At present, these requirements mark a distinct departure from those for direct credit and liquidity facilities to non-financial customers, although there is no reason for this distinction.

In their capacity as investors, banks would find it far more difficult to invest in auto ABS than at present. In their capacity as sponsors of ABCP programmes, they would find it very unattractive to maintain corresponding platforms for the securitisation of trade or leasing receiv-

1 The BDI communicates the interests of German industry to those in positions of political responsibility. It primarily addresses policy-makers and the government in Germany and at EU level. The BDI provides political flanking for the opening up of international markets and provides information and economic policy advice on all topics relevant to industry.

2 Deutsches Aktieninstitut represents the entire German economy interested in the capital markets. Its about 200 members are listed corporations, banks, stock exchanges, investors and other important market participants. Deutsches Aktieninstitut keeps offices in Frankfurt am Main and Brussels.

3 Verband Deutscher Treasurer e.V. is the official German association of Corporate Treasurers representing more than 1200 treasury professionals from 530 companies.

ables. At present, platforms of this kind are used by more than 100 enterprises in Germany. The total volume of resources generated via such platforms is around EUR 12 billion.

Therefore: Under the LCR, high-quality German auto ABS should be explicitly included in Level II at least, and the liquidity lines in ABCP programmes should not be placed in a worse position than corresponding liquidity facilities directly applied for non-financial customers.

2) Current proposals on the new rules applicable to underlying capital assets in bank securitisation investments ("Revision of the Basel II securitisation framework")

According to a discussion paper by the Basel supervisory authority dated December 2012 (Basel III.5), new capital adequacy requirements for banks with regard to securitisation positions are expected to be introduced as of 2015. This would result in a huge increase in capital requirements for ABS investments as well as for liquidity facilities in ABCP programmes.

In the first case, higher capital adequacy requirements would apply in many cases to the sum of all tranches than to the unsecuritised credit portfolio underlying a transaction. In the latter case, more capital would generally be required compared to the underlying unsecured credit lines to the enterprises themselves. From the perspective of capital adequacy, ABCP programmes would thus be uneconomic for offering banks as opposed to unsecured loans.

Viewed in the light of risk history, this makes little sense as the usual recovery rate for loans in the case of company insolvency is around 40-60%. However, in finance transactions based on securitising trade receivables, in the case of originator insolvency the normal recovery rate is 100%.This kind of revised framework for securitisations would also make it far more difficult for banks to invest in auto ABS than at present. At the same time, it would make it very unattractive for banks, as sponsors, to maintain ABCP platforms for their corporate clients.

Therefore: The capital adequacy requirements for high-quality auto ABS should not differ from the previous requirements for securitisation positions or from the capital requirements for comparable products (covered bonds, corporate bonds). The same should apply to the provision of liquidity lines for ABCP programmes.

3) Solvency II

New capital adequacy rules for insurance companies investing in securitisations are considerably diminishing the attractiveness of securitisation investments by enterprises in the insurance sector. For example, according to the most recent draft of Solvency II, ABCPs covered by trade or leasing receivables would have to have underlying assets of at least 19% of the company equity. By comparison, an AA-rated covered bond with a (residual) term of one year would have to have underlying assets of only 0.9% and commercial paper issued by an A-rated enterprise of only 1.4%. Investment in ABCP would therefore become unattractive, which is likely to make this instrument far more expensive for companies using this financing instrument.

The relations in the case of investments in AAA auto ABS compared to covered bonds or corporate bonds would be similar.

The result of introducing Solvency II without amending the present draft would therefore be that, to the extent that they apply the standard model, insurance companies would cease to invest in securitisations.

Therefore: The capital adequacy requirements for high-quality auto ABS and ABCPs should not differ from the capital adequacy requirements for comparable products (covered bonds, corporate bonds).

4) Shadow banking regulation / Money market funds (Draft MMF Regulation, Art. 7 and 8)

New investment guidelines for money market funds or securitisations in the present European Commission draft will make it more difficult to invest in auto ABS and ABCP programmes. Auto financing and leasing, even in the form of leasing of capital goods, are explicitly ruled out as underlying assets. Corporate receivables are allowed in certain circumstances, although the applicable conditions still have to be defined by the ESMA.

Therefore: Auto ABS and ABCPs with underlying auto financing should also be included on the list of investments permitted for money market funds.

5) CRA 3 (Art. 8)

The revised European regulation of rating agencies is intended to oblige banks in their role as originators or sponsors to publish detailed information on their securitisation transactions (ABCP and ABS) on a publicly accessible website. The extent of this publication and review obligation represents, first, a duplication of obligations already in existence (CRR Art. 406 et seq. and the ECB's loan-level data requirements). Second, as per the current state of the debate, the requirements far exceed what is necessary and practically feasible, particularly as far as the inclusion of ABCPs in the rule is concerned.

Therefore: No duplication and extension of existing tried and tested rules in Art. 407 et seq. of the CRR and the ECB's loan-level data requirements.

Comments

Association of German Banks
Reply to ECB/BoE Discussion Paper "The case for a better functioning securitisation market in the European Union"

3 July 2014

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General remarks

We warmly welcome the discussion paper prepared by the European Central Bank (ECB) and the Bank of England (BoE) on the case for a better functioning securitisation market in the European Union and appreciate the opportunity to respond.

Securitisations are an important risk-management tool for banks and businesses, enhance lending capacities, offer attractive investment opportunities and help to transmit monetary policy decisions. The positive views expressed by the ECB, BoE and other policymakers therefore send out an encouraging signal.

There nevertheless remain a number of impediments to an effectively functioning securitisation market. Securitisations are still suffering significantly from the aftermath of the financial crisis, even though many of them were not, and are not, comparable with sub-prime transactions.

The main obstacles to a revival of the market are new regulatory initiatives which are too focused on the type of securitisation that triggered the crisis and threaten to stifle sound transactions as well. Uncertainty surrounding the precise details of these initiatives in their final form is also hindering the market from moving in a positive direction.

Specific comments

Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?
Yes, a well-functioning securitisation market can provide various groups of investors with tailored investment opportunities. Securitisations are a useful funding tool for loans granted to the real economy by both banks and non-banks and can open up new lending capacity for these market participants. Securitisation can serve as a means of risk management and risk transfer for banks and also for businesses that securitise. Furthermore, securitisation structures can help securitising businesses and banks to exercise discipline in servicing the underlying assets, both internally and externally.

Senior tranches, in particular, are a good source of collateral for various transactions. They can serve as collateral not only for central bank operations, but also for repos and derivative transactions. Sound liquidity management (using repos, for example) and sound risk management (using derivatives, for instance) gives banks greater flexibility to lend, thus indirectly helping the real economy. In addition, a smoothly functioning repo market plays a key role in the transmission mechanism of monetary policy.

As a result of various regulatory initiatives (LCR, mandatory CCP clearing of derivatives and collateralisation of non-CCP-cleared derivatives) and market trends (e.g. towards collateralised funding), the need for collateral is set to rise by several trillion euros. The use of securitisations as collateral could consequently gain in importance if they were granted eligibility for collateral purposes in these cases too.

Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?
The discussion paper provides a good overview of the impediments to investors. The overarching problem of stigmatisation means that, even internally, each and every decision to securitise or to invest in securitisations is eyed highly critically and sceptically, if not rejected out of hand.

Along with the stigma attached, the biggest problem for the securitisation market lies in current regulatory initiatives. Regrettably, post-crisis stigma has resulted in the objective of regulatory projects seeming to be driven by a horror scenario featuring subprime RMBS and CDOs squared. Under the Basel Committee's most recent proposals, risk weights for investment grade-rated senior tranches would increase substantially by up to ten-fold. On top of that, the level of the risk-weight floor would more than double from 7% to 15%, thus unduly penalising even high-quality securitisations – however defined – such as auto loan ABS. Moreover, there is not only concern about existing plans for unduly severe treatment of securitisations but also a general uncertainty surrounding the precise final form of requirements and about what additional rules may be introduced.

As well as banks, insurance companies (Solvency II) and money market funds (Money Market Funds Regulation) will also face significantly greater impediments to investing in securitisations, or may even be prevented from doing so altogether. The proposal for a Money Markets Regulation currently envisages prohibiting money market funds from investing in ABS if the maturity of the underlying securitised assets exceeds 397 days or if the assets take the form of loans to retail clients for the purpose of buying a car, for example. This means that all major groups of investors are affected and, other things being equal, will invest less in securitisations in the future.

Given that the above initiatives (and the LCR) have yet to be finalised, uncertainty is currently a major matter of concern and, with few exceptions, is choking off the market for securitisations. Part of the problem is the absence of grandfathering arrangements.

We believe the lack of secondary market liquidity is largely due to uncertainty surrounding upcoming regulation and could be partially solved by ensuring the appropriateness of future requirements.

The financial crisis originally broke out in a specific market segment, the US subprime RMBS segment, which – as the name suggests – was hardly synonymous with high quality. Seven years later, the stigmatisation of all securitisations should not be permitted to undermine the revival of the market for high-quality asset-backed securities. For this reason, capital requirements for banks and insurance companies should not be increased simply because of this stigma and without any economic rationale. Instead, regulators need to recognise the benefits and the stability of high-quality ABS. This includes ensuring they receive treatment equal to that accorded to comparable instruments, such as covered bonds.

Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?
We essentially agree with the discussion paper’s conclusions. A further problem affecting both issuers and investors is that the regulatory treatment of securitisations is significantly more stringent than that accorded to comparable instruments such as Pfandbriefe. The costs generated by the regulatory requirements tend to make investors demand higher yields and issuers expect lower funding costs if, for instance, the underlying assets are also eligible for inclusion in a covered bonds’ cover pool.

Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?
Market liquidity is important to all financial instruments, albeit to differing extents. While secondary market liquidity is extremely important to shares, for example, this does not apply in equal measure to the securitisation market, where the investment strategy is often to buy and hold. This is also the result of the desired tailoring of many securitisation transactions to specific investors. We consider it important, too, to consider liquidity not only in the outright sale market but also in the repo market, which also offers the opportunity to raise liquidity at short notice.

The view of the Bank of England and the ECB is that a ‘qualifying securitisation’ should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a ‘qualifying securitisation’ not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?
We warmly welcome the idea of setting out certain criteria which characterise high-quality securitisations and defining instruments which meet these criteria as “qualifying securitisations”. It should not, however, be inferred that, conversely, all non-qualifying securitisations are badly constructed and dangerous. They simply display different characteristics. Furthermore, experience shows that the devil is often in the detail. The industry should therefore be closely involved in specifying and fleshing out certain of the principles. The self-liquidating criterion, for

instance, should not lead to the exclusion of auto financing with balloon payments, which rating agencies have found to deliver better performance than full payout agreements.

Since the crisis, a number of private-sector initiatives have tried to strengthen the securitisation market by awarding a type of quality seal to securitisations thereby signalling the fulfilment of certain criteria. Many of these same criteria are mentioned in the discussion paper. These seals of quality include the "certified by TSI" and PCS labels.

We would also like to point out that securitisations are, by their very nature, not simple in structure and thus automatically have a certain degree of complexity. Complexity should therefore not, in itself, be grounds for exclusion. Transparency is a far more important criterion. During the financial crisis, a lack of transparency frequently led to fire sales since investors were uncertain about the quality of the underlying assets. Even securitisations whose underlying assets were very stable in value were sold off in fire sales. This could have been prevented by greater transparency.

Since different regulatory initiatives are pursuing different objectives, we believe it will be very difficult to create a single, all-purpose set of criteria. The requirements for inclusion in the liquidity buffer may not be the same as those for the assignment of a lower risk weight. It would nevertheless be desirable for the criteria to be as standardised as possible. This will make it easier for both investors and issuers to assess the impact of different rules and regulations on securitisations and the positive effects of a "qualifying certification" will add up. It should also be borne in mind that issuers will try to fulfil the different quality criteria for different aspects of regulation in order to make their securitisations more attractive and target the broadest possible range of investors.

The discussion paper's description of securitisations as a risk transfer device highlights the positive effect of these transactions on banks' lending capacities. At the same time, however, it is asserted that synthetic transactions are more complex than true sale securitisations and should not, in consequence, be counted as a qualifying securitisation. In our view, a product's complexity is only partially determined by whether it takes the form of a true sale or synthetic transaction. We believe it is far more important to consider the entire structure of the securitisation, and also all the parties involved. The counterparty credit risk associated with synthetic transactions can be mitigated with the help of collateralisation mechanisms, including the posting by the collateral provider of cash collateral to be either deposited at the originating bank or held by a counterparty whose creditworthiness is beyond reproach and pledged to the securitising bank. In one respect, moreover, synthetic transactions are less complex than true sale transactions because the securitised assets are not sold on. On top of that, the use of synthetic transactions accommodates the potential objection of the bank's clients to the idea of their liabilities being transferred to a third party.

As we see it, therefore, the true sale versus synthetic issue should not be the sole criterion for determining whether or not a securitisation may be considered a qualifying securitisation. It is much more important, in our view, to focus on prudent lending practices, compliance with risk retention requirements, robust structures and transparency. This applies all the more given that transactions are subject to approval by national regulators.

The complexity of a true sale transaction, by contrast, is usually determined by the legal requirements which need to be met in a jurisdiction in order to ensure effective legal transfer of the assets to the ABS investors. With this in mind, a low level of complexity – however this may be defined – cannot in itself be considered a sound qualifying criterion. As well as meeting the criteria mentioned above (risk retention, robustness and transparency), these transactions should, above all, serve a financing purpose for companies in the real economy.

Paragraph 134 in Box 3 lists asset classes which may be considered qualifying securitisations subject to meeting all other criteria. We understand that this list is not supposed to be exhaustive. Nevertheless, we would welcome the explicit mention of trade receivables, which play a major role in funding the real economy. Particularly when used in asset-backed commercial paper (ABCP) transactions, these are assets of large and medium-sized companies generated in the course of their normal business (e.g. assets arising from delivery and performance) and are thus a key funding tool for businesses. It is noteworthy that these transactions performed well and proved stable, even during the crisis. In general, we support the transparency criteria for qualifying transactions. We would nevertheless like to point out that, owing to confidentiality concerns and a lack of available data at the real-economy businesses selling trade receivables in ABCP programmes, it is not possible to provide the same degree of detail about individual loans or assets as that which can be supplied by financial institutions. The excellent credit quality of these transactions is adequately demonstrated by the extremely low counterparty default rate on the receivables of large and medium-sized companies.

An inability to provide highly detailed information about the securitised pool on a scale which may well be possible in bank securitisations should not prevent ABCP transactions from obtaining a qualifying certification.

Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?
Provided the regulatory treatment is defined clearly and not too punitive, the result may be higher liquidity for the segment in question. Just as, for example, the central bank eligibility of certain assets tends to increase the liquidity of these assets also in private markets, a "qualifying certification" will be able to achieve this for securitisations as well. Both "central bank-eligible" and "qualifying" are/would be easily monitorable criteria and a reduction in complexity that enhance transparency and create a degree of certainty for market participants. At the same time, it should be ensured that investors do not rely solely on a 'qualifying certification' and do not dispense with any assessment of their own.

This will only be possible, however, if the regulatory framework for high-quality ABS is not tightened simultaneously.

These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?
The framework should provide for a transparent and robust securitisation market. The criteria themselves should be unambiguous, robust and clearly formulated to avoid legal uncertainty and to facilitate implementation.

Moreover, it should be considered that different regulations serve different purposes. Thus, it does not seem possible and desirable to define completely the same set of criteria for each regulation. By means of example, for hold-to-maturity investors liquidity is not as important as credit quality, whereas for banks' trading books liquidity and credit quality are very important. On the other hand, the criteria should be as uniform as possible to simplify assessment of adherence to high-quality criteria. This would further facilitate issuer compliance with different regulations. To increase the attractiveness of the ABS they issue, issuers probably will seek to comply with high-quality credit-related and liquidity-related requirements that add to the requirements as a whole.

Thus, we propose a building-block approach with a clear set of credit-quality-related criteria that have to be adhered to for credit products and a set of liquidity-related criteria that have to be adhered to for liquidity products. At any rate, it has to be avoided that criteria that refer to the same purpose are similar but not the same due to the fact that different regulators might have different opinions on their specification.

Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?
No. The level of harmonisation seems sufficient for the time being. It is more important to first observe the impact of the ECB and Bank of England loan level initiative. In addition, past experience with data harmonisation and software conversion shows that they are expensive. In most cases, the additional costs more than outweigh the benefits. Should further data harmonisation between the Bank of England and the ECB be considered, then not the maximum of both but the intersection should be selected. Moreover, such further harmonisation could only entail benefits if it included harmonisation with the US requirements, which could be a task for IOSCO.

Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?
A central location (website) where prospectuses are collected and made available may be helpful. It is also conceivable that fulfilment of certain requirements regarding the content and format of prospectuses could be part of a 'qualifying certification'.

Rigid pre-trade and post-trade transparency requirements are unsuited in our view to strengthening liquidity in securitisation markets. Where instruments are not continuously traded, the current price at which a purchase or sale would be possible may differ greatly from the last traded price (post-trade transparency). Mandatory pre-trade transparency could deter market makers or also just any activity in the market. Pre-trade and post-trade transparency should rather be the endogenous consequence of increased market liquidity. If pre and post trade transparency were a prior condition, liquidity could, however, be choked as a result.

To contribute to further improvement and standardisation as far as reasonable, the publication of best and sound practices on prospectuses based on analyses by the ECB or ESMA on a wide range of observed practices in the market could contribute to fostering market discipline. Further regulation should at any rate be avoided.

Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?
After implementation of the loan level initiative, the experience made with it should first be awaited. This initiative saw the establishment, in cooperation with various stakeholders (originators, investors, ECB, credit rating agencies, etc.), of data requirements regarded as sensible by these stakeholders. Some of the loan level data has only had to be reported to the ECB for a few months. We do not believe that any further expansion of reporting would be helpful at the present time.

In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?
We take a critical view of the disclosure of macro-economic data by issuers for two reasons. Firstly, many originators do not have their own economic departments to deliver the required

analyses. Secondly, the publication of such analyses could encourage 'herding' behaviour should investors base their investment decisions on these.

As concerns the loan level data, the above comments apply. After implementation of the loan level initiative, the experience made with it should first be awaited.

Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?
This would certainly make sense sometime later. But first of all, the conditions for meaningful benchmark indices, namely liquid secondary markets, should be created. The conditions for increasing secondary market liquidity therefore first need to be improved and any additional impairment avoided. When it comes to regulatory initiatives that will have a negative impact on secondary market liquidity of ABS, mention should be made particularly of the proposed Basel Committee on Banking Supervision rules on the trading book review, of the Money Market Funds Regulation, and of the planned liquidity standards.

Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?
Yes, as this would make clear to investors how ratings are produced.

How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?
Special insolvency rules would undoubtedly be helpful**.**

With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?
We expressly welcome the establishment of a joint BCBS/IOSCO task force to discuss developments on the securities markets and – as we understand it – potential measures to strengthen these markets.

A sensible approach in our view would be looking at the cumulative impact of all regulatory initiatives that directly or indirectly affect securitisations. Even though this is an ambitious undertaking, it should nevertheless be carried out in order to identify effects that may go beyond the regulatory objective that is directly pursued in each case.

To give but one example of such effects: even in the event that 'qualifying securitisations' are recognised as a liquidity buffer under the Liquidity Coverage Ratio (LCR), they will only be recognised in the lowest category (Level 2B). The maximum volume of Level 2B assets, measured against the entire buffer, will not be allowed to exceed 15%. Securitisations will have to "share" this 15% with equities, certain types of corporate bond and other assets. This means that it can already be said today that the positive impact of inclusion of additional securitisations would be limited. This limitation on securitisations would have an even more negative impact as soon as more "qualifying securitisations" are available in the market. In terms of liquidity regulation from a bank perspective, a growth in "qualifying securitisations" would therefore be virtually completely ineffective. A revival of the securitisation market would – as far as the LCR is concerned – fail to materialise.

Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?
Particularly for lending to SMEs, different rules apply within Europe (e.g. with regard to notarial treatment of loan agreements, definition of default). The non-uniformity of these rules is an obstacle to securitisation. Their harmonisation should therefore be sought.

Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?
Direct capital market access for SMEs would also generally be conceivable. At the same time, the continental European economy is strongly bank-based, so that indirect access via securitisation makes more sense in our view. Banks, as service providers, can enable particularly smaller businesses which do not want to issue bonds or securitise loans on their own to indirectly access the capital markets.

Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?
In principle, yes. However, how these principles are specified in detail is crucial. It is extremely important that they are specified in close cooperation with the industry to avoid unintended consequences.

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After studying the document "*The case for a better functioning securitization market in the European Union*", the organization which I chair, CEAC (*Employers of Construction of Aragon Confederation*) would like to make the following comments:

On 5 May 2014 the Board of the European Central Bank has taken a series of measures of accommodative monetary policy to support financing the real economy.

These measures include TLTRO with the condition that financial institutions which accept the same commitment to lend to households and non financial companies. However, the mortgage financing to acquire houses is expressly excludes of the TLTRO destination. This measure follows the model introduced at the end of 2012 by the Bank of England (BoE) and ending in early 2015 known as Funding Scheme For Lending but unlike proposed now by the ECB the mortgage lending for the acquisition of housing was not excluded of the financing. Moreover, this Funding Scheme For Lending is not yielding the expected results by the BoE, behavior that can also reproduce now with the measure adopted by the ECB.

Another measure is to relax the requirements of the collateral to be deposited with the ECB to access to its financing. A lack of more precise, have to check if the RMBA (residential mortgages backed assets) (securitization of retail mortgages) see more flexible their collateralization requirements to the ECB, which could favor the financing of real estate.

Finally, the ECB has also decided to intensify preparatory work for a purchase of securitization provided that an amendment to the rules of the securitization market will be performed, in which the securitization of mortgages supposed until the beginning of the crisis more than 60 percent. In this line, after the joint statement of the ECB and BoE of 11 April 2014 noting the need to encourage the European securitization market through Securitization of High Quality definition that can be securitized with a significant risk reduction, the ECB has opened a period of contributions until 04 July 2014 for proposals to improve the securitization market.

Against exclusion of financing the house purchase in the TLTRO nothing can make any European and Spanish business organization, although it highlights the fear that the ECB has the mortgage market, fear also shared by our business organization.

Our business organization believes that the market mortgage-backed securities is dry and while the same will not reactive it will be impossible the mortgage financing can flow to the European and Spanish real estate sector.

For these reasons, we include our proposals in English to encourage mortgage securitization market, based on the securitization of mortgages constituted by social housing in its broad concept according to the resolution of the European Parliament 11 June 2013 and/or housing affordable are qualified as Securitization High Quality (HQS) for its risk reduction and thus are favored by policy measures that encourage their securitization, generating resources for mortgage originators (financial institutions) may grant mortgage loans. We have presented these same proposals in the past to the European Banking Authority and the European Commission in its consultation on long-term financing, being one of the few European business organizations in the real estate sector which attended the public consultation of the European Commission and the only in Spain.

For your information, Aragon is a region of Spain with 47,719 km² in length and 1,340,000 inhabitants. The capital of this area is Zaragoza the fifth city of Spain. Furthermore, I am attaching mi curriculum vitae.

Kind regards,

José Luis Roca Castillo
President
Employers of Construction of Aragon Confederation (CEAC)
Plaza de Roma, F-1, planta 1ª, oficina 8
50010 Zaragoza (SPAIN)

THE CENTRAL BANK OF HUNGARY

Dear Sir/Madam,

The Central Bank of Hungary (hereinafter referred to as CBH) welcomes the Discussion Paper about *„The case for a better functioning securitisation market in the European Union*" prepared by Bank of England and European Central Bank staff. The document sets out the potential benefits and the various impediments regarding the secutitisation market. Furthermore, it presents the possible policy options authorities could consider, as the involvement in this market by the authorities may be desirable to support its revitalisation in a more robust form and we ask our apology to send our answer beyond the deadline.

Several documents have been released internationally analysing the securitisation market from different perspectives. In our opinion, the current discussion paper provides a profound and in-depth analysis of all the issues arisen. The relatively new element is the emphasized desirable role of the competent authorities to intervene in the securitisation market and consider the policy options aimed at alleviating the impediments identified. The CBH, as the competent authority in Hungary, examined the content of the paper and hereby sends you the observations and suggestions.

First of all, I would like to mark that in Hungary there is no legislation of securitisation in place hence the deal is not regulated currently. (The establishment of the SPV and the issuance of securities is possible due to the general rules of the Act on Civil Code and the legislation on the issuance of securities.) Furthermore, we do not have good practical grounding and experience in the securitisation market as there were just a few transactions in Hungary. We are presently examining the possibilities of the securitisation as an alternative funding tool, the proper aspects of a would-be legislation, the possible role of the CBH and the elements of an effective supervisory framework.

Impediments

We agree with the barriers identified to a well-functioning securitisation market in the EU, however we would like to mention one further possible impediment, which is the factor of getting the rating. In countries, where there is no credit rating agency registered and approved by ESMA and taking into consideration the costs and timeframe of its establishment, the fulfillment of this requirement could be problematic (e.g. SME loans).

Qualifying securitisation

The document states that it may be beneficial for the authorities to support the development of high-level principles that identify „qualifying securitisation". We would like to note that we support the word „qualifying securitisation" instead of „high quality securitisation" (HQS), as the latter may imply that any other category besides HQS is consequently low quality.

The CBH supports that authorities should set out clearly the criteria, as without differentiation the decrease of the securitised volume in the market may continue. At least a minimum list of criteria should be defined (by for example ECB or EBA) to avoid the „dilution" of the qualification (to avoid the situation that some countries use more lax criteria leading to worse quality – e.g. less transparent – issuances and undermining the confidence of the „qualifying securitisation" qualification).

Regarding the capital charges, we would be in favour of using different capital requirements, as a proper differentiation via qualifying would mean more transparency, a better ability to model risks, etc. In our opinion, besides the possibly different capital charges, the due diligence, disclosure and reporting requirements need to be treated by the same way for all types of securitisation. The discussion paper also notes that qualifying securitisations would not be risk free and investors need to conduct proper due diligence around these as well, as this kind of securitisation could be defined as security where risk and pay-offs can be consistently and predictably understood.

Disclosure requirements

On the one hand, the disclosure and reporting are extremely useful in the better functioning of the securitisation market and in promoting transparency, so we welcome the initiatives for further rules promoting transparency and financial stability. On the other hand, the requirements should not be burdensome and need to avoid duplication via the several relevant legislations. The ITS on supervisory reporting, the Capital Requirements Regulation, the draft RTS on structured finance instruments regarding Article 8 of CRA III, and on the other hand for the public the Prospectus Regulation and Transparency Directive contain (will contain) several requirements which should not be overlapping and put unnecessary burden on the participants.

We would like to raise the attention to the European legislation in force. The Commission Regulation (EC) No 809/2004 of 29 April 2004 - implementing Directive 2003/71/EC of the European Parliament and of the Council as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements - already contain rules regarding asset backed securities and this directly applicable regulation needs to be taken into consideration.

Furthermore, in our opinion it would not just be useful but necessary in the long run to have one single portal where investors can find all relevant prospectuses, standardised investor reports and other relevant information. In this context, we note that regarding issuances in relation to the Prospectus Directive, the authorised prospectuses and supplemental informations need to be currently disclosed on a portal established by ESMA as an obligation of the member states.

Broader questions

The discussion paper puts an emphasis on the role of competent authorities, specifically regarding the abovementioned policy options. We would highlight that the possible roles of the public sector (central bank, state, multilateral institutions) should also be considered. As the participation of multilateral institutions could also contribute to the successful securitisation transactions, it would be helpful to reach all the necessary information on their websites. The available information about the conditions to get a guarantee is limited. In our opinion, having updated information about these and read about best practices would be useful for countries where no guarantee was provided by multilateral institutions before.

Kind regards,

Gábor Butor

THE CENTRAL BANK OF HUNGARY

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REGULATION DEPARTMENT

CHENAVARI INVESTMENT MANAGERS

Response to the Joint Bank of England / European Central Bank Discussion Paper:

"The Case for a Better Functioning Securitisation Market in the European Union"

Chenavari is pleased to have the opportunity to comment on the joint Bank of England / European Central Bank discussion paper detailing the case for a better functioning securitisation market in the European Union. Below we give our responses to selected questions.

Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?

Chenavari welcomes the recognition of the benefits of securitisation by the Bank of England and the ECB. This recognition has been long awaited in the EU, where the market is only beginning to slowly recover when compared to performance in the US, and the support it gives to securitisation markets is encouraging progress for the return to normal functioning of the financial system.

During the early stages of the financial crisis, securitisation came to be widely and in our view erroneously regarded as being the root cause of the problem, which led to the public, bank executives and some regulators taking a negative view of the technique. It is true that some complex securitisations, such as excessively leveraged resecuritisations of existing ABS and CDO bonds, were unhelpful. However the majority of securitised asset classes, particularly in Europe, have performed well throughout the crisis due to more robust structures and stronger underwriting criteria for the underlying loans. It is therefore increasingly important to ensure that going forward, the whole of the securitisation market is not painted with the same brush, and different underlying asset classes receive treatment which is commensurate with their risk and historical loss experience.

There appears to be some welcome progress towards this goal by the introduction of the so-called capital surcharge supervisory parameter "*p*", in the updated consultation on securitisation risk weights from the Basel Committee on Bank Supervision.[1] There has also been an extent of differentiation in the EIOPA consultation on the proposed Solvency II calibration into Type A and Type B classifications.[2] In our view, this needs to go further – for example, the Basel Committee paper only divides securitisations into retail and wholesale categories, adjusting for granularity.

We particularly welcome the use of securitisation as a risk management tool for banks. This has too commonly in the past been referred to as "regulatory arbitrage", implying that banks use risk transfer transactions to reduce their capital base requirement and somehow "game the system". Yet in most underlying asset classes which cannot be hedged directly – particularly in the SME and trade finance spaces – portfolio securitisations, if well structured and genuinely transferring risk, are a highly valuable tool through which banks can control and manage their risk, and furthermore the only means by which the concentration of risks in the banking system, which were seen leading up to the crisis, is avoided. Effective risk management directly translates into increased capacity for banks to underwrite further loans, driving much needed economic growth.

Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?

Long-term regulatory uncertainty is a key stumbling block for investors and issuers alike. Even if the capital required to be held by banks against highly subordinated and high quality securitisation positions is set at an overly conservative level, for example the 15% risk weight floor in the Basel Committee proposal, certainty of regulation would allow the market to move on. At the moment there are multiple pieces of outstanding

[1] Consultative Document – Revisions to the Securitisation Framework, Basel Committee on Banking Supervision, December 2013
[2] Technical Report on Standard Formula Design and Calibration for Certain Long-Term Investments, EIOPA/13/513, December 2013

regulation proposals linked to securitisation, the majority of which have been outstanding for significantly more than 12 months. This increases caution in the behaviour of market participants and prolongs the stigma attached to the market. Such effects should not be under-estimated.

Level playing field issues arising from inconsistent regulatory treatment across jurisdictions is another important factor in our view, and global banks can frequently use jurisdictional arbitrage to avoid compliance, which necessarily weakens the investment proposal and alignment of interest between issuer/originator and investor.

Chenavari welcomes the development of more comprehensive market data for less developed asset classes, particularly if this is along the same lines of detail as the existing provisions in place through the European Data Warehouse. However, we believe that caution should be exercised when introducing standardisation to the market in terms of structures and documentation: it has already been noted in paragraph 50 that different objectives for securitisations require different market characteristics and even demand different investor bases, and a well-functioning securitisation market should have flexibility at its core.

Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to investors, and if so, what are they?

Issuers are subject to substantial regulatory uncertainty. As a concrete example of this, Chenavari has spoken to a number of European banks on a bilateral basis; they have informed us that their risk transfer programmes (backed by corporate loan and trade finance asset classes) are effectively paused until the regulatory landscape becomes clearer. Risk transfer has a direct knock-on effect to lending volumes. This is a clear example of how lending to the real-world economy is being impacted by the lack of clarity from regulators.

Chenavari welcomes the recognition of the difficulties of CLO managers to fund and hold retained portions. This is causing some difficulties in the CLO market, with issuance in Europe greatly reduced post-crisis when compared on a relative basis to issuance levels in the US. The net result of these difficulties is a consolidation of CLO managers, as only the largest players are able to survive. This in turn leads to increased correlation of names across portfolios and a paucity of choice and diversification for investors.

Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

Relative to government bond and corporate bond markets, the ABS market is small and necessarily more bespoke, requiring specialist analysis by investors. There will always be a liquidity risk premium attached to such markets. However, certain classes of master-trust RMBS and credit cards for example, trade very liquidly due to their uniformity of structure and collateral.

We believe that market liquidity will be aided primarily by increased issuance: supply is not meeting demand at the moment, due to continuing depressed issuance volumes and natural amortisation of older pre-crisis deals.

The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with

<u>this definition? What characteristics of a 'qualifying securitisation' not already include in the principles in Box 3 should warrant such treatments. Do respondents have any comments on the principles in Box 3?</u>

The understanding of the risks and pay-offs is directly correlated to the sophistication of the investors, and the definition of 'qualifying securitisation' appears to be a wide and subjective criteria. In essence, if the features of the transaction are clearly documented, then any investor should be able to model cash flows under their own set of assumptions. Structural robustness is often achieved by features which may be perceived as complex but are ultimately to the benefit of the investors – for example, over-collateralisation and interest coverage cash trapping mechanisms in CLO tranches.

Our comments and queries on Box 3 are as follows:

- The name 'qualifying securitisation' appears misleading, as this implies that non-simplistic securitisations do not qualify. We prefer the use of the term 'standard securitisation';
- Where do CLOs fit in, and how do they comply with "originated in the ordinary course of the originator's business"? (paragraph 131);
- Paragraph 129 on asset performance history could limit some issuers;
- Paragraph 139 would seem to assign operating advisor rights in CMBS to senior tranches;
- Paragraph 135 speaks of prohibiting synthetic risk transfer, however the fact that risk is transferred synthetically should not impact the behaviour of the transaction if structured properly. Indeed, a fully cash-collateralised synthetic tranche with collateral held within a ring-fenced account, while being of a legally different format, is extremely similar and can easily satisfy all the other criteria for a 'qualifying securitisation';
- As a general point, would the definition of 'qualifying securitisations' only apply to new issues, or would this take into account all existing securitisations as well? Not doing so might unfairly penalise secondary traded issues;
- We welcome moves to increase transparency in the market with initial loan level data and/or the provision of cash flow models. However, we note that cash flow models are typically already available for new deals through Intex and ABSNet, and that granular pool stratification data has almost always been available both for new and pre-crisis ABS;
- The availability of investor reports to potential investors is welcome, as these are generally only available to current investors at the moment, which gives poor access to comparables analysis. Standardisation across investor reports for certain asset classes may be useful, although note that different structural features across deals may make this impractical. However, standardisation of a number of simple performance metrics would be extremely helpful;
- We would expect all relevant information around 'qualifying securitisations' to be publically available, including the provision of rating agency performance reports, pre-sales and new issue reports.

<u>Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?</u>

In general, we support the concept of a qualifying certification and believe this would enhance liquidity. It should be noted however that this concept sounds very similar to the PCS initiative, which has not had any impact on the market. We believe that to have an impact, the concept would need to be linked explicitly to different categorisation for regulatory capital purposes and/or inclusion in liquidity ratio calculations.

As noted in paragraph 101, there is always the danger of considering even very highly subordinated tranches as entirely "risk free", and care should be taken that investors are not lulled into a false sense of security by this certification (as they perhaps were by AAA ratings pre-crisis). We are furthermore not clear who would award such a certification, what the costs of doing so would be, and whether such certification would be flexible enough to encompass new and more bespoke types of transactions (for instance in the SME asset class).

These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?

It would presumably be most suitable for the framework to be developed through a series of consultations with market participants, overseen by an independent body of securitisation experts chosen on a revolving basis from the regulatory space, banking industry, legal profession and investor base.

Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that is provides most value to investors?

Chenavari supports any changes bringing further harmonisation within European markets, as increased consistency always benefits market development. While loan-level data for flow securitisation asset classes such as RMBS and credit cards is by now quite well developed, the addition of standardised data for SME and commercial property loans would be particularly valuable in promoting these hitherto opaque underlying loans. However, the data requirements should not be so burdensome at least at first to discourage active market participation by issuers.

Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?

The Prospectus Directive has gone some way towards standardisation of prospectuses, at least in general terms. It is clear that more work could be done to standardise certain common features of an asset class (for example, definitions and specifications of Principal Deficiency Ledgers in RMBS transactions, and over-collateralisation test specifications in CLOs), and this would help to differentiate non-standard features.

However, due to the diverse nature of structural features in certain securitisations, it is unlikely that a master documentation template such as that employed by ISDA is achievable or even desirable in terms of legibility. Something that may be more achievable is a standardised template 'ideal' for each asset class structure, and a list of variations from that standardised template for each deal.

The availability of prospectuses was highlighted in a recent court case *Michael Timmel v Aviso Zeta AG* in the Courts of Justice of the European Union, which ruled that prospectuses should be available electronically and "without impediment", effectively meaning public availability without registration or fee payment. Although most investors have access to stock exchange accounts (for listed notes) and Bloomberg accounts, these represent paid for or registered services. Hence it seems likely that all prospectuses will be made publicly available in future, and to this end a common depository would be useful.

Investor reports are currently very much based on the deal templates of the trustee/servicer, and the quality of the information varies significantly. However, the items contained in the investor reports are generally driven by the documentation. Furthermore, non-standard features will require non-standard reporting. While greater standardisation is clearly appreciated by all investors in terms of ease of comparison across investment opportunities, as usual it is a balance between the benefits and the ultimate costs borne by the investors.

In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

The publication of aggregated data from banks in particular would be a very useful tool in assessing the overall performance of certain asset classes eg SMEs and corporate loans. It would also be useful as a comparison tool across bank issuers. Both the availability of bank data in a regularised format, and the lack of unified booking systems for loans, making aggregating across systems challenging, are the greatest impediments to this. The costs of providing these data in a standard format could well be significant.

Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

Regular publication of performance indices, for example in less transparent asset classes such as SMEs, on a jurisdictional basis, would materially add to the metrics available to investors. Examples of such indices are already produced by rating agencies as part of a generic performance index, but (i) these are only available on subscription, frequently to a premium service, and (ii) these only cover information the rating agencies see on already securitised deals. The inclusion of information from credit registers and aggregated data from banks/non-banks would expand the reach of rating agencies and give an overall picture of market performance not currently available.

Tradable indices however would not be so useful, as the disconnect between market price and theoretical value of the index could create an unhelpful feedback loop during times of stress, leading to knock-on liquidity effects in the securitised asset classes.

Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

Whilst this would be helpful information to use for comparison purposes for deals across jurisdictions, investors would frequently consider historical data and deal composition as part of their analysis in any case. Publication of a matrix of ratings would denote a large shift in the market, which is used to seeing only a single rating, and may be misunderstood by some investors who may underestimate the risk in this way. For example, the default of a deposit bank would have serious repercussions on the ability to get repaid, while the implied rating based solely on the collateral could still show a AAA grade.

The rating agencies generally take a holistic view of all the risks of a transaction into their assessment, as investors should also, to arrive at their final rating. Additionally, the effects of third party default are frequently correlated within their models as a double default effect, giving an implied rating little meaningful value.

How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

This would require significant changes in bankruptcy law across separate European jurisdictions and would therefore be highly complex to implement. The costs of providing such accounts would be passed onto the end investor, and would presumably outweigh the benefits.

With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?

For each policy option, the cost to the end investor(s) should be clearly proven to be outweighed by the benefits. It is also important that the processes do not become overly burdensome, particularly to issuers, but also to ancillary counterparties.

It is also very important to bear in mind that the market as a whole should not be over-regulated, as a robust market should be flexible enough to innovate and adapt to new structures and collateral.

Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

Chenavari would suggest the following additional policy options:

- Improved transparency, for example around credit estimates (shadow ratings) in CLOs and also in CRE loans and CMBS bonds, where the information is frequently opaque;
- Increased pricing transparency of secondary markets – clearer central governance of ABS trading with respect to pricing data. Whilst we understand that everybody has different prices, for example each market maker could submit their bid/offer to a central body or exchange on a weekly / monthly basis where they are available;
- Fairer regulatory treatment of ABS bonds versus holding the underlying risk – for example, the (proposed) disparity in the risk weight floor;
- There should be moves to limit further the impact of national banking secrecy regulations, which seriously restrict information disclosure to investors;

- Consideration should be given to modifying the sensitivity of the retention requirement across asset classes to be commensurate with the risk, or at least modifying the requirements for ‘qualifying securitisations’ clearstream | DEUTSCHE BÖRSE GROUP

Clearstream response to the Bank of England and European Central Bank to the Discussion Paper The case for a better functioning securitisation market in the European Union

Introduction

Clearstream Banking AG, Frankfurt and Clearstream Banking S.A., Luxembourg (jointly referred to as Clearstream) appreciate the opportunity to comment on the Bank of England and European Central Bank Discussion Paper: The case for a better functioning securitisation market in the European Union.

As a wholly owned subsidiary of Deutsche Börse Group, Clearstream is one of the world's leading suppliers of post-trading services including settlement, safekeeping, and administration of securities.

Clearstream Banking welcomes the opportunity to participate to this consultation around improvements to be brought to the functioning of securitization markets in Europe and fully embraces the objectives pursued by the Bank of England and the European Central Bank. We certainly support efforts to bring more transparency, liquidity and resilience in the daily operation of the securitization markets and more particularly the introduction of a "Qualifying Securitisation" framework, based on a set of public, objective, simple and measurable principles. The success achieved with similar initiatives adopted by other segments of the financial markets (e.g. the introduction of the STEP label for European short-term securities) should help to guide us in that regard.

Key concerns on the proposed concepts elaborated in the Discussion Paper

Clearstream would like to take this opportunity to comment briefly on loans, bilateral or syndicated, and specifically on points 22 and 23 of the discussion paper.

As a follow through of the efforts to ensure visibility in the Asset-Backed Securities (ABS) market in Europe with the mandating of the Euro Data Warehouse to be the data register for ABS' assets, a similar and more extensive mandate, leveraging on existing market infrastructures and expertise available within the International Central Securities Depositories (ICSDs), should be given for an integrated European loan registry and clearing system. Clearstream Banking participated between 2010 and 2012 in the ICMA's ERC efforts in defining a methodology for the use of credit claims as collateral for repurchase transactions using an established clearing and registration mechanism and system within established and well-regulated securities market infrastructures, also acting as operators of Securities Settlement Systems (SSS). Both ICSDs, the members of the ERC workgroup and the legal advice of ICMA confirmed the methodology in the schematic below where loans are registered in a central loan registry and clearing system.

The issues, namely the dematerialization, perfection, transferability of the collateral and the privacy constraints would need to be considered and dealt with within or outside such an infrastructural development. It is, however, our belief that loans, whether as an asset for securitisation or as a stand alone collateral in a transaction (repo or otherwise), should be registered and bilaterally (lender/borrower) validated within such a central loan registry. Additionally, in order to be a viable infrastructure, this registry should also be recognized by market participants and regulators as the only proof of existence as well as (registered) ownership of the said loan. Proof of ownership could for instance be done by empowering the dedicated loan registry and clearing system as the safe keeper of the physical loan contract, ensuring also the maintenance of beneficiaries ownership (lender or investor) and the timeliness (or not) of the loan's contractual flows. Data held by the registry, including payment and or contractual changes could be offered to rating agencies within the restriction parameters of the loan contract, ensuring a validated data set for these users.

Currently, the efforts by all parties in the ICMA/ERC endeavour have abated. Clearstream Banking, nevertheless, believes that this infrastructure would alleviate much of the risks associated with the issuance of securitized loans that can be used as collateral to meet various funding requirements. We would therefore recommend that one of the high-level principles of a "Qualifying Securitisation" (Box 3: Principles of a Qualifying Securitisation – External parties) should be that it must be cleared and settled in a recognised (I)CSD, as defined in the forthcoming CSD Regulation. An ongoing involvement of these (I)CSDs is a crucial factor for meeting the objectives and criteria laid out in the Discussion Paper and would add integrity to any future development of this market. We remain open to any discussions on the subject.

We trust you would have found these comments useful and remain at your disposal for further discussion. Should you have any questions please do not hesitate to contact:

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or
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Luxembourg, 4 July 2014.

to European Central Bank

Securitisation2014@ecb.europa.eu

to Bank of England

Securitisation2014@bankofengland.co.uk

Discussion Paper - The case for a better functioning securitisation market in the European Union

Dear Sirs,

Your jointly written paper is certainly a useful contribution to the discussion on this matter. Nevertheless, it does seem a little reductive compared with the ambitious contents of the European Commission Green Paper on long-term financing posted for consultation in May 2013, to which we replied by sending our observations.

The paper you wrote does in fact seem to place greater attention on the issues of managing lending by banks rather than on making the finance available needed for investment in the real economy. We feel that it would be useful in this respect to consider our thoughts contained in the paper we have attached, which, moreover, are in agreement with those already underlined in the European Commission Green Paper for consultation, mentioned above.

If we also consider that it is essential to restore the effectiveness of the ECB monetary policy transmission mechanism, it is preferable to concentrate much more on all means by which funds can be channelled to companies to provide healthy growth and to restore functional balance to the financial system.

The UK government has already taken prompt action in this sense in the strategic area of export credit, with a significant direct lending programme. And Comoi through its Advisory Board (Prof. Giovanni Barone Adesi; Prof. Giuseppe Corasaniti; Prof. Marco Onado; Prof. Victor Uckmar; Prof Giacomo Vaciago) and REF Ricerche have also already taken action in this direction with the creation of a specialist trade receivables fund reserved for institutional investors because, as already underlined in other international forums, it considers that funds of this type represent one of the possible answers to the credit crunch which has hit Europe in recent years.

We therefore believe that both the ECB and the BOE should pay careful attention to these models, especially considering that given their structural nature they have no impact whatsoever on systemic risks because an EU supervisory framework is already in place to guarantee full control over them.

We look forward to receiving any comments or observations you may have. Please accept our very best regards,

Yours Faithfully

Sergio Zoncada
CO.MO.I Group S.a.

Giacomo Vaciago
Ref.Ricerche

3/7/2014

Encl/

The case of a better functioning securitization market in Europe

In 2013 the EU Commission highlighted the issue of long-term financing in a Green Paper

1. One year ago the EU Commission posted a green paper on the issue of long-term financing of the European economy for consultation. The CO.MO.I. Group and REF Ricerche[1] replied with a paper on the questions raised. Institutional investors are showing growing interest in a new asset class as they see room for them to take on a new role in the economic cycle, by playing complementary role to banks[2]. The objective of the green paper was to establish a level playing field for EU countries in order to find and agree on policies to support investment and encourage economic recovery.

Is revitalizing securitizations a panacea?

2. The securitization market was given careful consideration in that reply paper. In the proposed new wave of ABS, the underlying assets should be loans to firms, instead of mortgage loans to households. This would be a welcome development, provided the securitization technique is used without harming the stability of the financial system.[3]
3. Moreover, securitization processes have often generated complex financial instruments, that are difficult to price properly. The pricing problem has been made worse by the practice of trading these assets over the counter, outside regulated and transparent exchanges. These factors can result in trading in ABS suddenly drying up, which can in turn produce severe liquidity shortages for financial intermediaries.[4]

Lessons learnt from the past should guide regulators as they draft new rules for a sound market

4. Therefore, in our opinion a revival of securitizations should be accompanied by a sound regulatory framework, in order to develop a market for ABS on firm grounds. Here, we share the view of the Financial Stability Board and the IOSCO. In two papers they have stressed the need to harmonize the rules at the international level in this field, on the basis of specific principles.[5]

The underlying is the key

5. Figures on securitizations in the US and European markets[6] deserve attention. They confirm that ABS are concentrated mostly on retail and consumer goods as well as mortgages. Only a small proportion relate to equipment and industrial goods[7].
   This composition leads to the consideration that a very small portion of those ABS have manufacturing activities as the underlying. In our opinion this is a key issue which deserves careful consideration if we want to succeed in aiding recovery.

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[1] A contribution to the public consultation on the European commission green paper "Long term financing of the European economy" by the CO.MO.I Group and Ref Ricerche as scientific adviser, June 2013. In its introduction it suggested that the title definition should be reworded as "medium and long-term financial resources for the European Economy" to more clearly express the underlying meaning that the supply of credit from the banking system had reduced sharply and is not expected to recover in the immediate future.

[2] A detailed analysis of the paradigm has been made by IIF and Swiss Re on "Strengthening the role of long term investors", 2013.

[3] It is to be noted that EMIR Directive (no.648/2012) will help move ABS from OTC markets to stock exchanges with a positive impact on pricing and transparency.

[4] Bao J.,Pan j. and Wang J. - The illiquidity of Corporate bonds - Journal of Finance – Vol 66 pp.911/946 made a series of remarkable considerations about the illiquidity of corporate bonds and the relative impact on pricing.

[5] Vayanos and Wang wrote on market imperfection "market liquidity: theory and empirical evidence – handbook of Economics and Finance , 2013 chapter 19.

[6] Graphs published on page 12 of the discussion paper.

[7] The reference to "leases" probably includes industrial machinery, but not for any substantial amounts.

6. When in the discussion paper mention is made of a "qualifying securitization" with references to features like simplicity, structural robustness and transparency[8], we presume that this will leave room to address the needs of the real economy. If we are to re-establish fundamentals and to sustain growth, it is the duty of all institutions to set rules and policies that inject funding into the real economy.

An efficient approach to meet the needs of the real economy is required

7. New investment is performing relatively poorly and the signals emerging from statistical reports remain in negative territory compared with pre-crisis levels. The BoE made an innovative attempt to link aid to banks with assistance for the real economy, but in relative terms the results are not as positive as expected.

Rules are important but not enough

10 On the same wavelength in the export field, at the end of 2013 the UK Government launched a programme of direct lending for the benefit of the foreign buyers of industrial goods made in United Kingdom, through its ECA's. An impressive amount of 1.5 billion GBP was allotted to initiate a new era where the liquidity premium is the key to competing on foreign markets.

A dynamic approach: the UK Government decided to play a new role on exports by injecting liquidity.

11 New specialist intermediaries can play a supplementary role. They can raise funds from institutional investors and channel them to SMEs and replace support which is no longer available from banks.[9]

New specialist financial intermediaries with balanced risk-return instruments can attract funding for SMEs from institutional investors

12 Another issue raised in the ECB/BOE paper is the "predictable performance" of a potential securitization. It is compulsory to show a transparent risk-return ratio to attract investors, with no hidden risks ("opaque forms"). "Standardization" and "investor's access to credit data" are also mentioned as two essential pillars for an efficient structure. Nonetheless, appropriate support for the distribution of risk is mentioned as a means of mitigating systemic risk in the banking sector.

13 In order to bring something new and innovative to this debate we wish to present our own experience, which began in 2009 at the start of the economic downturn. At that time we started to analyse exports and the related credit market. It was immediately clear that the progressive withdrawal of banks from export credit business - too expensive, given the capital ratio requirements - would make Italian firms unable to compete with attractive terms and conditions of payment for their foreign customers.

14 We drew up a plan: a fund buys receivables (letters of credit or promissory notes issued by foreign importers or banks) on a without recourse basis to create a balanced portolio managed by an internally developed and fully tested assessment and calculation system.

New rules to open the financial paddock…

15 Now, an analysis of institutional investors (pension funds and insurance companies) revealed an undeniable series of critical factors in their investment portfolios such as a high concentration of government bonds (mainly with a domestic bias) and a low and largely unsatisfactory return, not enough to match long-term pension fund or insurance company

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[8] Discussion paper, Chapter 4;

[9] Supervisory rules applied by EU directives and domestic legislation ensures and limits market access as well as imposing controls on the ground to prevent potential oversight risks

obligations.[10]

16 We thought of setting up a fund in a comfortable environment to welcome these investors to a safe haven by helping to channel funding to the real economy. We therefore created a specialised fund registered in Luxembourg in 2012 as a trade receivables umbrella fund. The first compartment licensed by the local regulator is named Italy Export Credit ("IEC")[11] and is designed exclusively to fund exports of industrial goods from Italy. We believe that firms which compete on foreign markets where most of their turnover consists of exports are the most efficient and innovative. On this basis institutional investors can invest in credit originated by the best firms with good returns and low risk because default rates on the transactions (0.007%) over the years (based on backtesting) are very low.

…and innovation

to increase competitiveness in industry…

..mainly abroad

while solving the long-term critical problems of institutional investors

17 The IEC compartment provides an effective response to the questions raised[12] because it has been structured step by step to meet the strict guidelines of Institutional investors and their local supervisors. The work done on that compartment generated a series of features which treat investors with respect to give them a full overview of the portfolio. Moreover, the particular nature of the underlying overcomes the issue of liquidity which is generated by inflows distributed over the years[13]. The portfolio manager's strategy is decidedly one of "hold-to-maturity", which allows investors to benefit from a higher return and avoids any short-termism approaches[14]. Last but not least, full transparency on costs is guaranteed by the regulator's supervision who is aware of all the fees and cost and must approve them.[15]

Credit funds as a new frontier of finance with an effective lending capacity supplementary to the banking system

18 Why are we talking about credit funds? In order "to go beyond securitisation" as it says in the paper. The reason is because this fund achieves the goals of a typical securitisation. It solves a series of issues (transparency, fee levels, liquidity), under the supervision of a national financial authority for the efficient protection of investors' rights. If the approach is efficient, not only securitizations but also credit funds as described can be brought into play, because after all it is the investors who have the right to the last word. And even more importantly credit funds inject liquidity directly into the real economy. There are no bogeymen hiding in the shadows here, after all the AIFM Directive (EU Directive 2011/61) clearly states that these new players must always be subject to "robust governance controls".

[10] The Chairman of the Italian insurance supervisory authority (IVASS), dedicated a chapter of his concluding remarks on its 2013 activities to the new role of institutional investors and their involvement in financing the real economy.

[11] Comoi Fund Sca Sif Sicav, established in Luxembourg in July 2012.

[12] Discussion Paper – Box No.5 on the "Determinants of market liquidity" focuses attention on a series of causes of market illiquidity.

[13] Trade finance receivables with an amortizing schedule for principal and interest on medium-term maturities.

[14] The IEC Issuing Document and the related investment guidelines clearly state the portfolio strategy.

15 The CSSF makes a careful analysis of all fees and costs before authorizing the release of the Issuing Document to investors.

04 July 2014

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CBI response to the discussion paper on securitisation markets in the EU

The CBI welcomes the opportunity to comment on the joint discussion paper by Bank of England and the European Central Bank 'The case for a better functioning securitisation market in the European Union'.

It is important to ensure that the finance system supports those growing businesses that will drive Europe's recovery and long term prosperity. The CBI believes that the revival of high quality securitisation markets will play a key role in achieving this, particularly by increasing the overall supply of finance for SMEs.

We agree with the paper's assessment of the performance of the European securitisation market. Despite poor performance in certain product segments, high quality European securitised products have consistently performed well since the crisis. For example, the default rate for Residential Mortgage Backed Securities (RMBS) is very low, at only 0.08%.

We support the paper's assessment of the key barriers to a better functioning securitisation market. We particularly believe that regulation or regulatory uncertainty is having a deterring effect on the securitisation market. Regulation is discouraging investors from holding securitised products, as seen in the impact of bank liquidity rules which, although softened since the initial proposals, risk hurting demand for securitised assets like securitisations related to autos, trade and leasing receivables. Solvency II also still has stringent capital rules for securitisations. Regulation is also constraining issuers, mainly because of the uncertainty around capital relief available under future securitisation rules. Getting the regulatory framework right is therefore key to any revival of the securitisation market.

There are also a number of other barriers that can better be addressed by market participants and regulators. In particular there is a need to support higher product transparency, strict quality criteria and improved risk management during the securitisation process, particularly for those products backed by SME loans. This is crucial to instilling investor trust in the system. A positive example is the PCS initiative (Prime Collateralised Securities) based on clearly defined rules for transparency, disclosure, lending, and credit processing. We also welcome the ABS loan level initiative of the ECB, the establishment of

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a central European Datawarehouse for securitisation transactions under the surveillance of the ECB.

We think governments and the public sector have a clear role to play in pooling SME loans to facilitate direct funding from the capital markets. In the UK we believe that the Business Bank can play such a short-term ‘participating originator’ role, transferring agreed risk into assets that will attract institutional investors. We also welcome the European Investment Fund’s guarantee instruments to support SME securitisation in the EU.

Reviving the securitisation market is a priority for businesses and the CBI looks forward to participating in discussing the various options for action.

Matthew Fell
Director, Competitive Markets

BU Center for Finance, Law & Policy

Boston, Massachusetts http://www.bu.edu/bucflp/
June 25, 2014

Cornelius Hurley and Ronald S. Borod*

comments on

"The Case for a Better Functioning Securitisation Market in the European Union"

a discussion paper prepared by the staffs of

The Bank of England and the European Central Bank

The following are comments to the above-referenced Discussion Paper (the "Discussion Paper"). While we, in our practice and teaching, focus on the banking and securitization markets in the United States, we are of the view that the Discussion Paper addresses issues which are as relevant to U.S. banking and securitisation activities as they are to banking and securitisation in the European Union. The economic headwinds faced on both sides of the Atlantic as a result of the financial crisis of 2008 are equally strong and the regulatory responses to the crisis are quite similar. While the below comments are informed primarily by our knowledge and experience in the U.S. financial markets, we trust that our comments will also be appropriate to the same issues in the EU.

Promotion of more robust SME lending is a desirable policy objective in the U.S. and the EU. Securitisation can play a meaningful role in this regard by, among other things, facilitating the creation of a secondary market for such credits and promoting efficient price discovery and more effective risk management tools. Below we will discuss an emerging marketplace for the securitisation of SME loans. We believe the lessons derived from this sector may be applicable to the broader economy and stand ready to provide further insight if it would be helpful.

Before responding to some of the individual questions posed in the Discussion Paper, for which comments have been solicited, we offer some observations on the inherent value and the inherent risks of the securitisation markets.

*Professor Hurley is director of the Boston University Center for Finance, Law & Policy, and Mr. Borod is Senior Counsel at DLA Piper LLP (US) and Adjunct Professor at Boston University Graduate Law Program in Banking and Financial Law. The views expressed here are their own.

The story of the Great Recession of 2008 is complex with many interwoven threads and causes. However, it is not just conventional wisdom but informed thought which has concluded that a recession of such severity and duration would not have been possible but for the potency of securitization. The same securitization process, of course, had previously produced historic levels of liquidity to economies around the world while simultaneously enforcing levels of discipline which produced sustained growth and exemplary performance for over three decades--all this notwithstanding several economic recessions and large-scale liquidity crises during that period.

Only when the use of securitisation was diverted from its original purpose of the creation of liquidity for the real economy and the disintermediation of financial risk and crossed the line into a trading and arbitrage vehicle for the financial sector (for which collateral quality became secondary or irrelevant) did it become a weapon of mass destruction as characterized by one iconic investor. It is our thesis that this central narrative element must be kept in mind in any discussion of how to enhance the benefits of securitisation without again unleashing its potentially destructive force.

Oversimplified analyses of how securitisation contributed to the Great Recession can lead to oversimplified remedies that are unhelpful or counterproductive. The "originate-to-distribute" model was certainly a contributor to the undisciplined underwriting of the subprime mortgage market; and the lack of "skin in the game" of the originators certainly had a corrosive effect on discipline and due diligence. However, it was not the originate-to-distribute model or the lack of skin in the game that caused the global banking system to seize up. To the contrary, had the banks simply underwritten bad loans and fully offloaded their exposure through subprime mortgage securitisation, the banking system would have been spared.

At the same time that the underwriting arms of the banks were packaging the poison, the proprietary trading desks of the same institutions were overdosing on it. Although the synthetic CDOs and the $CDOs^2$ were opaque and complex instruments, there were many other securitised products in the market in 2008 which were more complex and which performed admirably throughout the Great Recession. Complexity alone should not be viewed as an evil attribute. In fact, it was the uniformity and facial simplicity of the subprime mortgage securities and subprime CDOs that unleashed the staggering volume of issuance of these securities which overwhelmed the ability of the rating agencies, the monolines and the institutional investors who took positions in these securities to evaluate them properly.

We respect the views of the Bank of England's Andrew Haldane and take to heart his cautionary words about "fighting complexity with complexity". Nevertheless, we believe that even Mr. Haldane would agree with the following theorems:

Complexity ≠ Opacity,

and the corollary,

Simplicity ≠ Transparency

Our bias is not against judicious intervention, both to stimulate and regulate the securitisation market. Any intervention, however, must be based on accurate and properly nuanced assumptions about the causal connection between securitisation technology and the financial meltdown. The preeminent tasks of any form of intervention should be to (i) achieve desired results, (ii) do no harm and (iii) avoid unintended consequences.

Responses to Specific Questions. In the remainder of these comments we will respond to some of the specific questions posed by the Discussion Paper, as follows:

Q: *Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?*

A: Yes, generally. We do not, however, agree with the distinction drawn between the "liquidity" and the "credit transfer" functions of a securitisation. In our view, all securitisations involve some form of credit risk transfer regardless of the underlying credit quality of the assets. For example, the essence of securitisation is its "alchemy," to wit, the pooling of assets without credit quality into bankruptcy-remote vehicles that not only insulate the assets from the bankruptcy risk of the originator but also redistribute the risks inherent in the assets among investors through the creation of senior-subordinate securities or securities of differing durations. An investor may have perfect tolerance for credit risk over a three-year duration and not have the same tolerance for the credit risk over a ten-year duration. It is the business of securitisation to distribute these duration risks among investors based upon the investors asset requirements and their tolerance for duration risk.

Q: *Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, where are they?*

A: Generally, yes. Additional constraints on the re-growth of the securitisation markets include the following: (i) *Exit of the Monolines.* Financial guarantees on the senior tranches of ABS issuances backed by various asset classes were a huge stimulus to growth prior to the Great Recession. By enhancing investment grade ratings to AAA/Aaa levels, the monolines opened securitisation issuances to investors limited to the highest rating levels. Now that the monolines have exited, the volume of AAA/Aaa-rated securities has been greatly diminished, as has the presence of these AAA/Aaa-seeking investors; (ii) *Volcker Rule.* The Volcker Rule under Dodd-Frank, which was intended primarily to prevent regulated financial entities from taking on inappropriate proprietary risk, in defining the scope of its coverage has adopted an overly broad definition of "covered funds" that includes any activity that would be covered by the 1940 Investment Company Act but for the exemptions under either section 3(c)(1) or 3(c)(7). This has prevented many regulated financial institutions from investing in ABS products which rely upon the section 3(c)(1) or 3(c)(7) exemptions—thus depriving the securitisation market of an important investor base, a result which surely seems to be without any supportable rationale. While a US-centric issue, its spill-over globally is noteworthy.

Q: *The view of the Bank of England and the ECB is that a "qualifying securitisation" should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a "qualifying securitisation" not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?*

A: The "qualifying securitisation" section is premised in part on the assumption that complexity is bad and simplicity is good. However, as stated above, this approach misconstrues the lessons of the Great Recession and, specifically, the connection between securitisation and the financial meltdown. Complexity was not what converted what had been previously beneficial financial products into toxic assets. In fact, some of the more complex instruments of the esoteric ABS sector in the U.S. weathered the storms of 2008 through 2010 better than some of the simpler securities outstanding during that period of time. Therefore, to single out simplicity as the differentiating quality of a "qualifying securitisation" which will earn it some special status in the regulatory scheme is likely to have unintended consequences. To repeat: complexity does not equal opacity.

If securities are so complex as to be opaque, or for other reasons (such as the substitution of credit default swaps for real assets as their collateral) are incapable of rational scrutiny or a rational rating methodology, then such securities deserve to be placed in a separate category of the "less worthy." On the other hand, toxicity can be packaged in a simple box. The differentiating factor should ultimately be the quality of underwriting and structuring, and the challenge is that that may be as difficult to define in the abstract as obscenity. It has been the responsibility of the Nationally Recognized Statistical Rating Organizations to scrutinize these attributes, and thus the question must be asked whether a governmental attempt to separate the wheat from the chaff can be as or any more successful.

Q: Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

A: There are no silver bullets to support the growth of securitisation markets while at the same time protecting against the irresponsible use of securitisation technology. We would like to call to your attention, however, an experiment occurring in the U.S., involving solar asset securitisation, which may be instructive in this regard.

Under the auspices of the National Renewable Energy Laboratory, an offshoot of the U.S. Department of Energy, designed to stimulate renewable energy investment in the U.S., a group has been formed known as Solar Access to Public Capital (SAPC). SAPC consists of approximately 160 members, including major law firms, accounting firms, solar developers and installers, solar component manufacturers, operation and maintenance service providers, management service providers, independent engineers, banks, and other participants in a growing solar energy market. The purpose of SAPC is to create the conditions under which the solar market may have increased access to the capital markets through the use of securitisation technology and other means.

Among the initiatives being undertaken by SAPC are: (i) the creation of standardized solar leases and solar power purchase agreements for the residential and commercial solar sectors in the U.S.; (ii) the creation of mock securitisation structures, term sheets, cash flow models, and data sets which are being presented to the NRSROs in an effort to solicit feedback and to educate the rating agencies themselves on the solar sector; (iii) the dissemination of best practices in the O&M, installation, and independent engineering sectors of the solar industry; (iv) the collection and dissemination of performance and credit data on distributed solar assets, both residential and commercial, and (v) the preparation of white papers on various legal, tax and accounting issues affecting the solar sector.

Over an 18-month period while SAPC has been in existence, the first two rated solar securitisations in the U.S. have been issued (although there is no direct causal connection between the SAPC initiative and these offerings), a robust solar deal pipeline has begun to form and a meaningful dialogue has been created with the NRSROs. All of this is clearly contributing to accelerated growth of knowledge and acceptance of the securitisation of solar assets by the rating agencies, potential issuers, and investors. Although SAPC is still a work in progress, it does provide an illustration of how government intervention and the harnessing of private sector expertise can be used to accelerate the growth of securitisation in a specific market sector.

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The success to date of the SAPC project makes even the most skeptical commentators (including these responders) hopeful that external forces, properly focused and calibrated, may make a positive contribution to the growth and the discipline of the securitisation market. It may be that the barriers of information asymmetry in the market for SME loans can be overcome by similar focused initiatives on a sector-by-sector basis. This approach may not be "simple" but it certainly will be worth the effort if the reward is an enhanced securitization market and an improved economy.

We appreciate this opportunity to provide the above commentary.

The case for a better functioning securitisation market in the European Union

Response by the Council of Mortgage Lenders

to the Bank of England and European Central Bank joint discussion paper

Introduction

1. The CML is the representative trade body for the residential mortgage lender industry that includes banks, building societies and specialist lenders. Our 120 members currently hold around 95% of the assets of the UK mortgage market. In addition to lending for home-ownership, the CML members also lend to support the social housing and private rental markets.

2. We are grateful for the opportunity to respond to the discussion paper jointly prepared by the Bank of England and the European Central Bank on the securitisation market. In our response, we confine our comments to that segment of the securitisation market that is secured by residential mortgages (RMBS).

3. In our opinion, a fully functioning RMBS market is a critical component in the overall funding mix for UK lenders. Individual lenders will continue to make their own choices of how to fund their asset portfolios and specifically their residential mortgage portfolios, based on a series of factors (cost, maturity profile, investor distribution, currency diversification, etc.). We would see the RMBS market as part of that funding mix alongside retail deposits, wholesale senior unsecured funding and covered bonds.

4. We support any initiatives that ease the ability of lenders to access a variety of funding markets. A diversified funding mix can contribute to the financial stability of individual lenders and systemic stability.

5. In particular, we consider the proposed changes to the status of SPV bank accounts would be beneficial. In addition, we strongly believe that a review of the status of RMBS within the LCR should be considered. By allowing a wider range of RMBS assets and a greater proportion of such assets to be held as part of the liquidity stock, would have significant beneficial impacts to the liquidity of this product.

Overview

6. Issuance volumes for UK RMBS securitisations are below the peak levels seen in 2005-2008. This is due to a number of factors (alternative funding markets, UK lenders shrinking balance sheets). However, the current market conditions are supportive for UK RMBS issuance. The improvements as outlined above could be implemented to extend access to this funding tool.

7. Immediately following the financial crisis, investors were, not surprisingly, cautious over a number of financial instruments including securitisations in general. As a result, financial markets, but particularly the securitisation markets, were effectively closed. This reflected concerns over the structure of securitisations and a broader stigma of the product in general, in which UK RMBS were also branded, perhaps unfairly. As confidence has returned to the wholesale markets, particularly over the last two years, there has been a selective return of investors to the securitisation markets. We would highlight the performance of UK RMBS over this period as evidence of the robustness of the UK RMBS product structure and the quality of the underlying mortgages. There has been no default of a prime UK RMBS during this period. We would emphasise that the degree of investor appetite has varied between different securitisation products. UK RMBS is considerably better received by investors than other, more exotic, securitisations e.g. collateralised loan obligations (CLOs). In that sense we would draw a very clean distinction between high quality robust UK RMBS and other forms of securitisations.

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8. We would, therefore, characterise the current market conditions for UK RMBS as one of where there is demand for the product among investors, but this demand is tempered by the effect of regulatory uncertainty and the threat of the punitive capital requirements proposed under Basel III and Solvency II. In addition, the smaller volumes of issuance reflect the more attractive funding opportunities that have/do exist in other markets for example the use of the Funding for Lending Scheme (FLS) or the covered bond markets. In particularly, the use of the FLS has meant we have seen a substitution effect whereby lenders used the FLS rather than the RMBS market. Given that the FLS is no longer available to fund mortgage portfolios, we would expect a pick up in issuance in the RMBS market, although recognise that at this point in time, other wholesale markets e.g. the covered bond market still offer more attractive funding levels than the RMBS market. Furthermore, a number of UK banks continue to shrink their balance sheets and hence the requirement for wholesale funding is reduced, with a commensurate reduction in the need to use the RMBS market.

9. While, therefore, conditions in the RMBS market may not be as poor as issuance volumes might suggest, we recognise that they could still be improved. This would have the potential to increase the volumes of RMBS issued and/or improve the pricing lenders can achieve in this market.

Feedback on selected questions highlighted in the Discussion Paper

"Do respondents agree that market liquidity may be a barrier to a well functioning securitisation market?"

10. The lack of market liquidity has been an impediment to the continued recovery of the RMBS market. Regulatory developments have played a significant role in taking market liquidity out of the system. Some regulatory developments e.g. Solvency II have made the asset class less attractive than alternatives and therefore investors have left the market, or reduced their asset allocation to the product, thereby reducing market liquidity. At the same time trading desks of investment banks, both proprietary but also those providing secondary market liquidity, have been more risk averse and have required more capital to be held against positions, which has also impacted the overall secondary market liquidity.

The view of the Bank of England and the ECB is that a "qualifying securitisation" should be defined as a security where the risk and payoffs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a "qualifying securitisation" not included in the principles outline should warrant such treatments?

11. The process of defining a "qualifying securitisation" is one beset by a myriad of issues and is extremely complicated. Broadly we would agree with the outline in the discussion paper but note that the "devil is in the detail". We would mention that, in defining which covered bonds should qualify as suitable securities to form part of the liquidity stock for banks, the process involved considerable time and negotiation. Inevitably, during that process some types of covered bonds were therefore excluded from the definition of covered bonds that qualified as liquidity instruments. While we are entirely confident that UK RMBS would qualify as some of the strongest securitisation products in Europe we would re-iterate that we would consider it critical for UK lenders that UK RMBS form part of the "qualifying securitisation" to ensure UK lenders had access to the fullest range of wholesale funding markets. We welcome the comments within the discussion paper that indicate that the expectation would be for RMBS to fall within the criteria, as outlined by the principles shown, of a qualifying securitisation.

Do respondents think that a liquid market for "qualifying" securitisations used for funding would result from a "qualifying certification"?

12. While prima facia such a policy development might produce a liquid secondary market, we remain slightly sceptical on any impact for either UK RMBS or UK covered bonds. We would highlight that there already exists at an industry level accreditation process for both covered bonds and securitisations. For securitisations the industry have developed an accreditation process i.e. Prime Collateralised Securities, aimed at promoting the ABS market as a sustainable tool for both funding and investments. In the RMBS market, both Nationwide and Santander have had their UK RMBS benefit from the PCS accreditation. A similar process has occurred in the covered bond market with the creation of a covered bond label by the European Covered Bond Council. We would be uncertain whether an additional level of accreditation would add much value. While on the margin, it may

improve liquidity, the additional cost of undertaking such a process may not be justifying in an improved funding cost generated by better secondary market liquidity. We would instead suggest that central banks build upon the industry lead initiatives. In particular, recognising the industry lead process and including RMBS within the LCR (see below).

Do the respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or are there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to the securitisation markets?

13. The existing levels of transparency that originators of UK RMBS undertake are sufficient for investors. Alongside the information provided in the prospectuses and investor reports, we would highlight that the credit rating agencies provide a further level of information for investors on this segment of the securitisation market. We would also mention that UK lenders continue to have regular and extensive investor relationship programmes.

Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets?

14. We would contend that given the level of credit data available to investors in UK RMBS already that there would be minimal benefits to investors for further disclosure.

How important do respondents see the impediment related to the availability of ancillary facilities?

15. We agree with the comments in the paper that the lack of highly rated financial counterparties able to provide the ancillary facilities to securitisation SPV's (standby facilities, swaps etc.), is currently an impediment to the growth of the market. The combination of ratings requirements and exposure concentration means that only a few financial institutions can provide such facilities and, therefore, the cost of such facilities is currently relatively high.

Would the benefits of facilitating SPV bank accounts that fall outside the originators insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

16. Such a policy initiative would have the potential to widen the universe of providers, which should make availability of such facilities more common and reduce the cost. We would, therefore, welcome such a move.

Do respondents think there are other policy options authorities should consider to support the emergence of a simple, transparent and robust securitisation markets?

17. The discussion paper highlights the BCBS liquidity requirements. We would note that the Bank of England liquidity requirements are even more restrictive. We believe that there is scope for a relaxation of both. In terms of liquidity etc., we consider that UK RMBS would be on a par with covered bonds. In this regard, the current draft of the LCR not only gives lower credit to securitisation as an asset class but also even excludes revolving securitisations from Level 2B assets and thus potentially a large proportion of the UK RMBS market. We think it is essential that the finalised delegated act should involve revolving securitisations. It would, our opinion, make sense to have RMBS on an equal footing within the various liquidity regimes. By doing so, it would (re)introduce a number of investor's i.e. financial institutions to the RMBS market that would greatly support liquidity and trading environment for RMBS. The corollary to this would be tighter funding levels and improved issuance volumes.

18. If you have any comments or queries regarding this submission, please contact Jon Saunders, jon.saunders@cml.org.uk or +44 20 7438 8934

23 June 2014

Response to The Bank of England / European Central Bank Discussion Paper:

The case for a better functioning securitisation market in the European Union

By:

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Tamar Joulia-Paris, Brussels

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3 July, 2014

The numbered questions below correspond to those listed on page 25 in the Discussion Paper (DP).

1. **Do respondents agree with the benefits of a well- functioning securitisation market as outlined in Section 2?**

While acknowledging this paper's extensive review of the securitisation market's impediments and economic value, the narrow scope and somewhat directive structure of this discussion paper is surprising. If policy makers are still seeking to both boost financial stability and sustain economic growth, focusing only upon the benefits from and the approaches towards reviving securitisation certainly raises eyebrows, especially given the systemic risks that securitisation can foster[1].

This is not to question the need for change, economic flexibility and efficiency. Nor is it to argue against securitisation, per se, and the desirability of developing new funding channels for the real economy. Rather, the concern is that securitisation may be used in several different ways, some of which are less constructive. Consequently, any consideration of how to reform and revive this market should take both its desirable and undesirable characteristics into account. Policy should then, presumably, focus upon what might usefully be retained and what needs to change.

Working from such a mindset. the following submission argues in favour of further structural change to simplify this market and mitigate the risk of replicating the debilitating uncertainties and the negative feedback loops that were so evident during the 2007/8 Global Financial Crisis (GFC)[2]. It also seeks to reduce externalities and inefficiencies by the least disruptive means possible.

Nonetheless, questions remain around

- What structural changes are most urgent?
- What characteristics should a revived market contain?
- Whether the suggested approach, combined with all policy initiatives to date, will yield a "robust" securitisation market[3]?

As further explained below, we remain uncomfortable with the ambition and direction implied by this DP. Our sense is that material market uncertainties will remain and that these will prove critical in the next crisis. We also believe that what is being proposed will significantly increase compliance costs while having a less pronounced impact upon fragmentation, transparency and behavioural issues.

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[1] E.g. through shadow banking and financial network interconnectedness and as referred to in DP para 97

[2] After all, the uncertainties generated were as destabilising as the actual losses realised. And just because losses only crystallised in one geographic market should not be mis-construed as an absence of risk elsewhere.

[3] As per DP para 1

At the same time and in light of the DP's apparent intent, we have limited our response to highlighting concerns, gaps and areas for additional focus. As such, we defer a broader analysis and discussion of "what should be revived and why" as well as discussion of securitisation's role within the financial network. Similarly, discussion of securitisation's impact upon the monetary transmission mechanism, shadow banking, bank competition and long-term lending is also deferred since these topics appear to be beyond this DP's scope.

2. **Do respondents agree with the impediments to and economic concerns of investors that have been identified?**

We agree that impediments need to be removed and with many of the specific obstacles listed.

Market simplification

Beyond the listed impediments, this market is characterised by significant entry and participation hurdles and an inherent tendency towards complexity and inefficiency. In particular, the requirement for up-front expertise and significant monitoring investments imposes high joining costs upon investors. Combined with elevated, on-going monitoring costs, as discussed below, this is a major impediment[4].

That so much investment is needed is symptomatic of the market's fragmentation and complexity. In the past the common assumption appears to have been that market forces will resolve these cost issues. Such an approach would also align with the Efficient Market Hypothesis (EMH) and a "light touch" regulatory philosophy. However, the GFC and the Bank of England[5] itself have cast doubt on this reasoning. Furthermore, a reliance upon market forces here is inconsistent with the expressed desire to diversify funding channels and to revive a robust securitisation market.

It is also relevant to note that complexity in the securitisation market can refer to many things including market fragmentation, incremental counterparty risk considerations, legal (heterogeneous enforcement) risk, an apparent lack of policy tools to tackle behavioural issues as well as regulatory conservatism/misalignments and regulatory ambiguities in the securitisation market. And there are important ambiguities around loss recognition (accounting) frameworks, how much capital supports credit risks transferred beyond the banking sector and the effect of repurchase agreement and derivative based risk transfers[6] on counterparty exposures and market dynamics.

[4] see DP para 11

[5] see the discussion of the securitisation market's inherent tendency towards complexity in Haldane, Madouros 2012

[6] e.g. ,structured hedging using credit default swaps,(CDS)

Consequently, there is an urgent need to encourage simplification and standardisation across Europe's securitisation markets. The European Parliament has made this same point[7].

Furthermore, there is an important and generally un-quantified degree of shadow banking activity in the securitisation market. This creates tremendous uncertainties when market stresses take hold. The DP has not really considered this issue. Presumably, the logic is that if regulators focus upon ensuring a well-capitalised regulated sector, this will be enough to weather any asset price volatility arising from excessive speculation by non-regulated shadow banks. We question whether this will hold true as shadow banking assumes an increasingly material share of the financial network (which, arguably, it already has).

Infrastructure change

We do not doubt that this market will, eventually revive one way or another. We also note there are self-reinforcing economies of scale here. However, one key question is in what form will the market revive and will this then lead to ever improving economies of scale? Or will there be a repeat of the market collapse that followed the GFC? Our view is that a robust market can only take hold in the wake of a determined policy intervention.

Expanding upon the above points structural change should target:

I. Behavioural issues: including a lack of aggregate (market level) transparency, an absence of transaction-specific accountability and several dysfunctional market dynamics and externalities[8]

II. Complexity: including the above-mentioned participation hurdles

III. Misaligned and ambiguous regulation.

And some of these structural changes would appear to have a greater urgency than what is suggested in the DP, as further noted in our responses to questions 15/16 below.

a) Do respondents think that there are any additional impediments to investors, and if so, what are they?

Yes. In addition to the above behavioural, complexity and regulatory alignment issues, investors will be concerned about oversight effectiveness and policy makers' ability to manage negative feedback loops in times of stress. These capabilities affect investors' perceptions of and confidence in a market.

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7 see EP 2012, particularly the accompanying notes

8 as referred to in Section 2 within the DP

We are also surprised that information asymmetries, information costs and the need for systemic risk monitoring have received such little attention in this DP. In our view, the fundamental issue confronting securitisation lies with the risk/reward ratio offered to investors. Economic theory generally assumes efficient markets with zero information costs. This is a simplifying assumption. The reality is that information sourcing and processing is the most significant discretionary cost confronting investors[9]. And information costs balloon the more heterogeneous, discontinuous and dispersed the information is. As already mentioned, Europe's markets are highly fragmented and complex.

Furthermore, taking a simplistic, passive approach towards participation costs ignores the reality that investors have a choice as to where they invest. Consequently, prices for seemingly comparable assets in the securitisation, corporate and sovereign bond markets are diverging. The reason why securitisation prices tend to be lower is because the added information costs and complexity investors face[10]. These impact the risk/reward profile for this asset class[11].

It is also worth highlighting that information costs extend well beyond the mentioned participation costs. Interestingly, this DP's transparency discussion focuses primarily upon ensuring disclosure about the underlying loan collateral and securitization structures. The guiding philosophy appears to be that increased disclosure will provide the transparency needed to secure investment[12] and effective competition. We expect investors to disagree. What is needed is timely, well-structured and easy-to-use information, not just more granular data. Data overload already exists in the European market.

Risk migrations within the financial network and regulatory arbitrage

While the dimensions identified in this DP all contributed to the uncertainties and negative feedback loops witnessed during the GFC, there were further sources of instability as well. In particular, most market participants struggled to understand where credit risk had migrated to within the economy, the extent to which losses had been recognised and how much capital supported the transferred risks. This information gap remains to this day. The importance of providing a continuous helicopter view (overview) on these issues as well as a proposed solution for supplying this continuous overview is further explained in the response to questions 15 and 16 hereunder.

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[9] A point obliquely acknowledged in DP para 11
[10] see DP para 94
[11] we ignore temporary factors, such as financial repression, here
[12] akin to the point also anticipated in Haldane, Madouros Aug 2012

3. **Do respondents agree with the impediments to and economic concerns of issuers that have been identified?**
   a) **Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation?**
   b) **Do respondents think that there are any additional impediments to issuers, and if so, what are they?**

The proposed approach will increase already material compliance costs for issuers. High compliance costs create barriers-to-entry for smaller issuers. While these may be ignored in a rapidly expanding market, they are material in this case.

4. **Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?**

5. **The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition?**
   a) **What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments?**
   b) **Do respondents have any comments on the principles in Box 3?**

We strongly support efforts to standardise information and markets. Standardisation tends to simplify markets. It also enhances confidence and liquidity by lowering market opacity.

6. **Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?**

7. **These principles (see Box 3 5 above) may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed?**
   a) **What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'?**
   b) **What are the associated risks?**

8. **Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets?**
    a) **If so, which asset classes should be targeted?**
    b) **How can accessibility to the existing loan level data be improved, so that it provides most value to investors?**

Yes, conversion software will bring benefits. However, much stronger benefits would be realised if the regulatory approach were harmonised.

9. **Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements?**
    a) **Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?**

We strongly agree with providing investors with a single portal for information. In this regard, ESMA's efforts represent an important step in this direction[13].

10. **Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets?**
    a) **Would credit registers be helpful in this respect?**
    b) **If so, which asset classes should be targeted?**
    c) **In what form could access be granted to ensure that borrowers' confidentiality is preserved?**

11. **In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?**

The proposed industry-level data would, of course, be very useful. Nonetheless, as previously noted, simply generating more granular data is not desirable. Investors already face data overload[14]. Compliance costs are a further consideration.

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[13] however, ESMA's draft RTS does provide for reporting exceptions which may result in material monitoring gaps

[14] DP para 106 refers to an example of this.

12. **Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?**

We agree that credit and market indices per asset class and per country would be useful. At the same time, we don't think that key indices will, or can emerge on their own, as further explained in our response to question 15 below.

13. **Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?**

14. **How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?**

15. **With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?**

Information costs and completeness

This DP focuses upon increasing transparency for transaction-specific risks, notably on the underlying collateral's performance. Specifically, it notes that "… further improved and standardised data availability may be needed to enable investors to assess the credit risk inherent in the securitised assets…"[15]. However, as mentioned above, this is only one of several material risks confronting investors[16]. Of these, aggregate market level risks (e.g. liquidity, systemic, regulatory etc.) are even less transparent than those of the underlying assets. These aggregate risks need continuous and independent monitoring if exposures are to be managed.

Stated more simply, the securitisation market[17] is missing a well organised overview (or "helicopter view") of the market. This overview needs to cover metrics such as participant demographics, exposure concentration and interconnectedness metrics. And any investor trying to generate such an overview will quickly find that the required data is missin due to confidentiality

[15] See ECB/BoE Mar 14, P 6
[16] this is akin to a commercial real estate investor only validating the credit-worthiness of his fixed-term lessees while ignoring relative real estate prices and changes in the supply of office space in the vicinity
[17] and, more broadly, the credit risk transfer market

concerns and competitive pressures. That is, information costs and incompleteness are virtually insurmountable problems for a private initiative here. As such, this overview information gap can only be closed by a public good. Without such an initiative, this gap will persist and there will be opacity around where risks are migrating to within the economy and how much capital supports the transferred risks[18].

Simplify to lower costs

Our main proposal is for policy to focus upon lowering information and compliance costs by simplifying this market's structure, regulation and oversight.

Specifically, policy initiatives might usefully focus upon streamlining due diligence and monitoring costs, so that securitisation becomes more cost competitive with alternative financial instruments[19].

Support to systemic risk management

Effective and efficient systemic risk monitoring is essential to a robust securitisation market. As far as we understand, this DP seeks to rebuild issuer and investor confidence. Yet it does not consider the aggregated information, needed to manage systemic risks and negative feedback loops. We therefore propose that this information gap be added to the impediments list for this DP and that this information gap on credit flows between financial institutions be closed.

That said, this DP does refer to the FSB's monitoring initiative for systemic risks[20]. Such monitoring, as presently described, will not fill this information gap for portfolio level credit risk. Beyond our previously expressed concerns with the FSB's monitoring framework[21], we would highlight that Investors and Issuers require this systemic risk information just as much as supervisors do. And they need such data on a continuous, rather than annual basis.

16. **Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?**

[18] particularly for risks transferred outside of the regulated banking system
[19] e.g. sovereign and corporate bonds as well as covered bonds
[20] see ECB/BoE May 14, para 98
[21] see Campbell, Joulia-Paris, Jan 13

Clarity of vision and completeness

In general, this DP's proposals appear to be relevant and pragmatic in as far as they go. However, they also seem oriented towards supporting short term trading strategies rather than long-term underwriting and investment. One of the key questions, from our perspective is: "What is needed to make securitised financial instruments as appealing to investors as sovereign and corporate financial instruments?" Answering this question should lead to a clearer vision of what must change. Similar to our response to question 2 above, key structural changes would:

I. Maximise maturity transformation efficiency by actively simplifying and standardising this market (changing the market's infrastructure and dynamics)
II. Reduce policy ambiguities with more holistic regulation (e.g. functional regulation) and clearer competition policies
III. Develop a helicopter view and a range of supervisory tools to manage systemic risks (i.e. for both crisis prevention and crisis resolution purposes)

The challenges in achieving these changes (e.g. regulatory alignment, new European legislation, market and standards co-ordination across national boundaries not to mention resistance from entrenched interest groups) should not be underestimated. Nor should the costs of ignoring these issues.

The Need for a Public Good

All of the above points call for a bolder approach than is implicit in this paper. Specifically, public infrastructure is needed to deliver a public good in the form of consistent, well-structured data that market participants themselves cannot otherwise capture Such a public infrastructure will simplify the markt and provide essential transparency on systemic risks. Without it, we fear that destabilising uncertainties will re-emerge from this market during the next crisis, just as they did during the GFC[22].

Turning to the proposals within the DP , it is not clear how some of the points made will actually be realised. For instance, how will the transparency arguments underpinning the observation that "… risks [should be] distributed across the financial system in a transparent and diverse manner…"[23] come about? If the regulatory framework continues to ignore shadow banking, how will supervisors and investors know where the risks have migrated to?

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[22] As indirectly suggested in DP para 18
[23] DP para 17

Regulatory and policy alignment

Reducing capital requirements for qualifying securitizations is necessary, but aligning these requirements across banks, insurers and other financial institutions is probably as important to avoid undesirable arbitrage.

17. **Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?**

As further discussed in our response to the EC's Long Term Funding consultation[24], reducing vertical integration in the banking sector and encouraging service providers would be a useful initiative.

18. **Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?**

Although all of the proposed principles are relevant, we believe that a further, important principle should be that a "qualifying" securitisation be one that is traded in a transparent market (i.e. where aggregate market metrics and flows are readily visible). We believe that a public monitoring utility is needed to provide this visibility. Such a utility's specific role will be to capture and convert granular, transaction data into benchmarks and aggregate reports on where credit risks are migrating to within the financial network.

What will change as a result of adding such public infrastructure? From a market operating and existing compliance process perspective, relatively little. Financial Institutions will continue to negotiate and underwrite collateralized risk transfers as before. And risk sellers and risk buyers will still need to agree prices, respective accountabilities and enforcement protocols. However, this added monitoring will capture aggregate market dynamics irrespective of each participant's regulation and the transfer instruments used. Consequently, investors will be better informed and market liquidity and stability will improve.

[24] see Campbell, Joulia-Paris Jun 2013

Glossary

CDS	Credit Default Swap
DP	Discussion Paper
EC	European Community
ECB	European Central Bank
EMH	Efficient Market Hypothesis
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
GFC	Global Financial Crisis
RTS	Regulatory Technical Standards

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CREFC Europe response to joint Bank of England and European Central Bank discussion paper of May 2014: *The case for a better functioning securitisation market in the European Union*

CREFC Europe is grateful for the opportunity to comment on this discussion paper (the **DP**).

CREFC Europe is a trade association promoting a healthy, sustainable and successful commercial real estate (**CRE**) debt market in Europe. Our core membership includes lenders and intermediaries who help connect capital seeking the risk and returns of CRE debt with real estate firms seeking finance. We seek constructive and effective dialogue with non-originating investors, borrowers and regulators in promoting CRE debt markets that support the real economy without compromising financial stability.

Our response to the DP should be seen in that context: we are concerned not with the debt capital markets per se, but with the overall CRE debt ecosystem in the context of the CRE market and the real economy as well as in that of capital investment markets. We believe that commercial mortgage backed securities (**CMBS**) have an important role to play in promoting the health and diversity of that ecosystem, helping to reduce volatility and risks to broader financial markets. Given our membership and expertise, our comments are for the most part focused on CRE and CMBS.

Below, we set out a brief executive summary, followed by some more general comments prompted by the DP. **Appendix 1** provides essential context and background about the role and importance of CRE and CRE debt for Europe's economy and financial stability, without which CMBS cannot be properly understood. Our specific responses to the questions posed by the DP are set out in **Appendix 2**.

Executive summary

We are encouraged by, and support, the DP. We welcome its aims and the pragmatic, balanced and strategic perspective it adopts, as well as the clear, principles-based approach it proposes for differentiating within the securitisation market.

Other, more advanced, work streams seek to identify a privileged 'high quality' part of the securitisation market. We hope that, where appropriate, ways can be found to 'retrofit' definitions developed by other work streams with good ideas emerging from this initiative. We fully appreciate that regulatory harmonisation will not always make sense; but where it does, this more considered process should not be disadvantaged simply because it lags other work streams.

CMBS and CRE are quite different from most other ABS asset classes, and certain principles that may seem obvious for other asset classes do not make sense for CMBS. Most ABS asset classes involve the securitisation of homogeneous, naturally small scale and granular, consumer loan products. By contrast, individual CRE assets (and thus CRE loans) are large scale, inherently heterogeneous and part of a business, rather than consumer, market. A well-functioning European securitisation market for CRE debt (CMBS) is part of the solution to the challenges posed by CRE debt to market participants and financial stability, not part of the problem. Appendix 1 elaborates.

We agree with para 126 of the DP that the aim of principles-based designation of securitisations should be to make the assessment of risks more straightforward, not to provide an opinion on credit or other risks. However, we disagree with some of the proposed principles, most notably the suggestion that receivables should be entirely self-liquidating (para 132). Some degree of refinancing risk is an inherent and very common feature of CRE lending. It is perfectly susceptible to being analysed and evaluated, given appropriate information and expertise (and improving market transparency is a key CREFC Europe aim). Full amortisation is neither reliably effective nor practically achievable in CRE lending markets. There are other, better ways of protecting CMBS from the cyclical tendency in CRE lending markets to under-estimate loan refinancing risk. See further our responses to Q7 and Q18 in Appendix 2.

General comments

Policymakers are faced with a number of competing and contradictory concerns and objectives where securitisation is concerned.

(a) Parts of the ABS market (including some European CMBS) performed poorly during the crisis, and there is an understandable perception that the 'brand' is tarnished and a desire to ensure that the mistakes of the past are not repeated. Securitisation should therefore be **punished**.

(b) There is a growing recognition that the debt capital markets have an essential role to play in supporting the financing of the real economy, stimulating growth and tackling unemployment. 'Real economy' securitisations should therefore be **rehabilitated**.

(c) There is a new sensitivity to financial system stability and resilience, and an awareness that securitisation can help to disperse risk originated within the banking system. Securitisation is to be **encouraged** if it transfers risk out of the banking sector.

(d) Regulatory supervision is being extended to a broader range of financial institutions with economic or potential systemic significance. From that perspective, securitisation might be **dangerous** if it transfers risk into non-bank financial institutions.

These political, economic, macro-prudential and micro-prudential considerations are not easy to reconcile – and striking the right balance is especially difficult where there is political pressure, urgency and imperfect understanding and trust between regulators and industry. We believe that progress has been erratic so far.

In our view, the two most useful objectives that regulators should set for themselves if they wish to encourage the emergence of well-functioning securitisation markets in Europe are:

(a) to ensure that regulated entities that are natural ABS investors, such as insurance firms and pension funds, are not inappropriately disincentivised by their own regulatory rules from investing in ABS; and

(b) to promote, as broadly as possible across the ABS sector, best practice in the way securitisations are designed, structured and sold. Transparency regarding transaction documentation and the features and performance data of the underlying loans and security should be central to this.

We see the balanced, strategic perspective and principles-based approach adopted by the DP as a very positive step towards the second objective (albeit subject to some important comments, discussed below). However, we are concerned that there are few signs of progress so far towards the first objective, and are particularly troubled by the way relevant aspects of Solvency II have evolved (also discussed below).

However, we are concerned that regulators have tended to regard CMBS as an odd and problematic corner of ABS markets, rather than recognising it as an extremely valuable tool for addressing some of the problems of the wider CRE debt market. A revitalised, well-functioning CMBS market in Europe could bring better transparency to more of the CRE debt market, enhancing economic and financial system resilience by improving diversity both in the sources of CRE debt capital, and in the range of CRE debt products available to the CRE industry. In considering CMBS, regulators must understand:

- the particular characteristics of CRE;
- the functional importance of CRE to the real economy and the role of debt alongside equity for the CRE industry;

- where performance is considered (either explicitly or implicitly), the context of the wider, unsecuritised CRE loan market, rather than merely comparison with other ABS asset classes; and

- the implications for financial stability of the structure, composition and depth of the CRE debt market and of the way CRE, credit and regulatory cycles interact.

The volatility and poor performance of CMBS relative to other ABS asset classes during the crisis is no justification for regarding CMBS as a flawed and problematic product. Most of the problems affecting CMBS flowed from the operation of the underlying CRE lending market – and against that benchmark, CMBS did not perform poorly. Aspects of CMBS that might seem problematic viewed from a broader ABS perspective (for example, lack of granularity, or the fact that underlying loans are rarely self-liquidating) are neutral, natural characteristics of a debt product linked to the CRE market.

We firmly believe that CMBS, like the underlying CRE lending market, must be improved, and CREFC Europe is at the heart of industry efforts to achieve that. We need regulators to support those efforts, not stymie them by imposing impracticable and inappropriate conditions when designating a privileged category of securitisations.

We would be delighted to discuss any aspects of our submission with you in greater detail and to support your efforts to improve Europe's securitisation markets in any way we can. Please contact me (details below) in the first instance.

Yours sincerely

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Appendix 1: Introduction to CRE and why CRE debt securitisation matters[1]

CRE in the economy

CRE is a central part of our built environment, without which cities and society as we know them could not exist. It is generally regarded as including not only offices, shops, logistics and industrial space, but also professionally managed rental housing, student accommodation, assisted living, hotels and leisure. According to European Central Bank figures, real estate in all its forms accounted for more than 17% of value added and more than 7% of employment in Europe in 2013.[2] Studies[3] indicate that the commercial property sector alone had a market value of some EUR 5 trillion and directly contributed EUR 285 billion to the European economy in 2011, comprising around 2.5% of the total economy and employing over four million people – making CRE bigger than both Europe's automotive industry and its telecommunications sector.

Commercial property is where we work, shop and relax, and includes rented housing, student housing for the young and assisted living accommodation for the old. It is also a vital enabler of economic activity, capable of supporting or constraining employment and growth. A large and healthy CRE investment market provides incalculable value to the economy by allowing businesses to rent premises flexibly according to their changing needs. Around half of the EU's commercial property is leased by businesses that like the flexibility of renting and are reluctant to commit the capital and management time required by owner-occupation. That allows them to focus on their business and optimise their use of capital, minimising their exposure to the relatively volatile, opaque and cyclical property market. Those who own their premises can use them as collateral, improving their access to finance.

The CRE cycle and capital flows

CRE is by its nature fundamentally long-term, illiquid and capital intensive, at two levels.

- It takes time to build, alter or remove buildings to satisfy the constantly changing needs of businesses and investors. As demand fluctuates with the ebb and flow of broader economic cycles, CRE businesses risk anticipating it incorrectly. The non-fungible nature of CRE, where each building is unique in terms of the combination of its location, purpose, specification and age (and thus value), makes it even harder to anticipate demand accurately.

- Investing money directly into CRE takes much longer than investing in bonds or shares – typically weeks or months rather than minutes. Furthermore, transaction costs are high for CRE, so longer hold periods are generally required before investors can expect to achieve a positive return.

The fact that the supply of bricks and mortar cannot be expected to match either the pace of occupier demand for space or the flow of capital into the sector means that a CRE cycle is inevitable. When rising demand for buildings cannot be met by increased supply, values go up; and reduced demand is reflected in falling values, as buildings cannot suddenly be removed to restrict supply. Judging supply/demand cycles is an essential part of the skillset for CRE businesses and CRE investors: get the timing right, and you can see the value of your assets increase, but get it wrong and you can be stuck

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[1] This section of this submission is substantially derived, but adapted, from the Overview and first Appendix of *A Vision for Real Estate Finance in the UK*, a report published in May 2014 by the Real Estate Finance Group (**REFG**) with the support of the Investment Property Forum (**IPF**). See https://www.ipf.org.uk/home/vision_for_real_estate_finance/default.aspx. CREFC Europe acknowledges the copyright of the REFG and the IPF in the source text.

[2] See http://www.ecb.europa.eu/pub/pdf/mobu/mb201406en.pdf, pages S51 and S54.

[3] See *Real Estate in the Real Economy*, a report by the European Public Real Estate Association (**EPRA**) and the Association for Investors in Non-listed Real Estate Vehicles (**INREV**): http://www.epra.com/media/Real_estate_in_the_real_economy_-_EPRA_INREV_report_1353577808132.PDF.

holding assets no-one wants. The economy benefits most when CRE market participants generally get it right, enabling markets to remain broadly stable: occupiers get the space they want (delivered at the right time and in the right locations), and capital is deployed into the sector at an appropriate pace.

CRE investment is a capital-intensive business with a traditionally significant structural reliance on some element of debt finance. CRE is a depreciating asset class that requires periodic capital investment to maintain marketability for occupiers and investment value. Capital investment may involve wholly new development, redevelopment, adaptation, extension or change of use, refurbishment or modernisation. It is often attractive for CRE businesses to pair equity capital (which demands a high return for the high risk it is willing to tolerate) with debt capital (which is content with lower returns because it takes less risk than the equity).

Various commercial considerations – chiefly associated with the availability and relative cost of raising and holding different forms of capital – influence the extent to which businesses use debt. As a general matter, leverage amplifies risk and (up to a point) returns for the equity invested, because debt is generally a fixed cost, payable before equity returns. If the business fails to generate sufficient returns to meet debt costs, it will fail and the equity investment may be lost. On the other hand, after debt costs are met, all further returns represent a greater proportionate return on the equity invested. In many countries, the differential tax treatment of debt (the cost of which is deductible) and equity (returns on which are not deductible) may incentivise some businesses to use more debt. Other businesses may balk at the risk, financial discipline and operational constraints that debt entails.

Choices around what kind of capital to raise are particularly important in capital intensive industries like CRE, and play out in different ways depending on the context, as well as the strategy and preferences of the CRE business. The risk and return calculation, and the pricing of different kinds of capital, are different depending on the underlying property and the borrower's strategy.[4] Across the industry as a whole, there is generally an important place for debt, but the proportion varies greatly, depending on the owner, the asset, the stage of the building's lifecycle and the market cycle.

Its size as a sector and its characteristics as an investment also make CRE an important asset class for investors. It offers relatively stable and secure long-term returns (represented by rents and capital growth) while routing long-term savings into this important element of the economy's capital stock. In mature markets, income typically accounts for the majority of the total return from CRE over the long term. Income performance is also characterised by low volatility across the cycle (capital returns can be much more volatile).

Within the broader CRE asset class, CRE debt represents a lower risk, lower return option for investors (alongside its function of providing CRE owners with the ability to leverage their own equity investment). The attractions of lending against the security of land and buildings are so obvious that they are sometimes overlooked. As capital returns from CRE are relatively volatile, it is safer to lend against the rental income that CRE generates. However, despite its relative volatility and illiquidity, the underlying capital value of land and buildings is an extremely valuable security that few other forms of lending offer.[5]

CRE lending can be conducted in a safe way based on a sound understanding of CRE asset, portfolio and market risks and appropriate terms and pricing – but it is not always conducted safely. Lenders (both

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[4] For example, the asset may be a speculative or pre-let development project; or the borrower may be seeking to refurbish and/or reposition an asset which it already owns or is acquiring; or the borrower may simply be purchasing a stabilised, income-producing asset. Each of these scenarios will present a very different proposition for a prospective lender.

[5] Lending against development projects (which do not produce income during the construction phase) is not suitable for securitisation and requires a specific skillset, delivering higher returns to reflect the greater risk as compared to lending against income-producing assets.

traditional and new) can be attracted by the ease with which capital can be deployed in CRE debt and the apparent (but illusory) safety of lending into a rising CRE market. Limited barriers to entry and the perception that no specialist expertise is required can lead to substantial CRE finance entering the market with neither local market knowledge nor a proper portfolio-level risk assessment. There is also a temptation for CRE debt investors to focus on lending volumes and required returns, which can be objectively assessed, rather than on risk, the assessment of which is more subjective. The effect is pro-cyclical, with excess liquidity and competition among lenders driving CRE values up and underwriting standards down. It is largely more bullish capitalisation rates, rather than actual earnings, that drive values up as the boom approaches its peak.

It would be a good thing (both for reducing CRE market volatility and for financial stability) for this pro-cyclical feedback loop between CRE and credit cycles to be addressed. It needs to be tackled at the level of the primary CRE lending market, because that is where it arises (and *A Vision for Real Estate Finance in the UK* makes specific recommendations to that end).[6] The securitisation of CRE debt simply allows exposures to be transferred: treating CMBS as if it were responsible for problems in the operation of the underlying CRE lending market would simply concentrate exposures in originating institutions, notably commercial and investment banks.

A side effect of the use of CRE as collateral by non-CRE businesses is that it increases the systemic importance of CRE both to the banking system and to the economy as a whole. As CRE values rise, the equity of businesses in the wider economy increases, improving their access to credit. Conversely when values fall, access to credit is reduced, its cost increases, and the sustainability of existing debt (particularly in the short term) can be compromised. CRE debt markets are especially important to SMEs, which generally have a more limited range of options for accessing finance than larger enterprises.

Historically, the vast majority of European CRE debt has been originated by European (and to a lesser extent overseas) banks. In the last cycle, some of that debt was securitised into CMBS, potentially providing a relatively flexible and liquid way for other investors to gain exposure to CRE debt risk and returns in the secondary market. A reasonably transparent and liquid secondary market is important because most non-bank sources of capital – even those with relevant expertise – lack the infrastructure to originate CRE debt themselves. That is particularly the case outside the major urban centres and for smaller sized loans so, again, is especially important for SMEs in the wider economy.

There are various ways of linking CRE borrowers to non-originating sources of CRE debt, including the syndication market, structured products, covered bonds (where covered bond markets exist) and CMBS. Only covered bonds and CMBS are designed to create two-way secondary liquidity, and only CMBS can do it in a way that takes the risk out of the banking system. But while the CMBS market has effectively delivered those benefits in the US, it has made a more limited contribution to diversifying the sources of European CRE debt.

In Europe, the market share of CMBS was roughly 10% of CRE lending prior to the financial crisis (it was more than double that in the US). Towards the peak of the market in 2006 and 2007 much of the credit risk distributed via CMBS was later revealed to have remained within the banking system. When the crisis began, banks found themselves holding the majority of European CMBS exposure on their balance sheets. It is worth considering why CMBS has not attracted greater participation from 'real money' investors in the past and how their greater involvement could provide a more stable source of capital in the future. This history certainly justifies looking closely at the performance and practices in CMBS –

[6] Notably, Recommendation 4 proposes the use of a cycle-insensitive, long-term value measure in the calculation of LTV ratios for the purposes of lender risk management and (where applicable) capital rules. See the report, referenced in footnote 1, for further details.

and CRE debt markets more generally – and for tackling problems that the crisis highlighted. However, it does not justify regarding CMBS as a fundamentally flawed product.

CRE debt and financial stability

CRE lenders and debt investors cannot make super-profits on some transactions to compensate for losses on others, because their upside is limited to their finance charge. For that reason, lending to CRE businesses (like lending generally) should be a less volatile and risky business than equity investment, particularly for banks and other systemically important financial institutions (**SIFIs**). The supply of CRE debt should respond to demand from those with specialist expertise in CRE, who are willing to take the risk of investing the equity capital at their disposal. CRE risk taken on by SIFIs should be properly understood and priced by those institutions, and reflected in adequate equity reserves in line with appropriate regulatory capital rules. Problems arise if that does not happen.

At the market level, the amplifying effect of debt manifests itself through its pro-cyclical impact. Leveraged investment exacerbates swings in prices and amplifies booms and busts in real estate, in turn exacerbating banking crises. In various countries, substantial cyclical CRE lending by SIFIs – helped by the persistently cyclical nature of regulatory responses – has often resulted in large banking system losses on CRE. In recent years, there has been a structural shift to shorter-term CRE debt prompted by the regulatory framework applicable to banks, as well as the demand for greater operational flexibility from many CRE industry borrowers. As CRE lending volumes are highest in the few years before a crash, a market dominated by three to five year CRE lending is especially vulnerable to large-scale defaults when many loans mature at the worst point in the cycle.[7] Short-term loans are also, of course, effectively impossible to amortise fully during their term.

Three features of CRE debt are crucial to its role in the CRE cycle.

- The speed with which debt capital can flow into or out of CRE dramatically amplifies the CRE cycle. Data[8] show that, while the amount of equity capital invested in CRE in Europe was broadly stable each year in the period 2001-10, the proportion equity comprised in total capital flows into European CRE was around 45% in 2001-04 and 50% in 2008-10, but only 28% in the period 2005-07. Both the rapid growth in CRE prices in the boom and their steep fall in the bust were largely driven by the behaviour of CRE lenders, rather than by equity flows into CRE.

- The majority of lending is advanced during the exuberant phase of the cycle. The optimistic mind-set of the boom informs how market participants value CRE cash flows and perceive the risk of loss, and can even affect the related regulatory capital requirements.[9] Moreover, as the cycle progresses towards its peak, the use of traditional loan-to-value (**LTV**) measures will tend to drive overall lending volumes higher. With insufficient capital built up during the boom, lenders can find themselves very exposed after a crash, with many outstanding loans no longer covered by the value of the property on which they are secured. As the crisis showed, the consequences for the

[7] It can be difficult, in such a scenario, to distinguish between stressed or defaulting loans where the difficulty is temporary and forbearance justified, and cases where the underlying fundamentals of the loan and collateral are weak and enforcement, sale or restructuring may be more appropriate.

[8] See Figure 1 (Drivers of the CRE cycle) in *A Vision for Real Estate Finance in the UK* (referenced in footnote 1).

[9] Historically, regulatory capital frameworks generally either pro-cyclically encouraged banks to move up the risk curve (where capital requirements were not risk-sensitive), or were vulnerable to optimistic interpretation (where capital requirements depended on models or judgment).

financial system, the taxpayer and the economy as a whole can be very damaging when SIFIs find themselves in that position.[10]

- The competitive environment of the boom favours borrowers over lenders in terms of risk-adjusted returns. In theory, both borrowers and lenders take more risk as LTV ratios rise and loan margins fall. However, borrowers will have progressively less equity at risk as the cycle progresses, and are therefore the residual beneficiaries of any cycle-driven mispricing of CRE debt. Such mispricing occurs because competition encourages lenders to reduce the margins they charge, even as rising values increase both their risk of loss and the amount they have at risk. It seems likely that cycle-related pressures increasingly tempt lenders to price loans by reference to their cost of funds (which will be lower late in the financial cycle), rather than on the basis of relevant risk characteristics. This state of affairs suits the more entrepreneurial and risk-taking parts of the property industry, but is unhelpful for financial stability.

The experience of the last few years fits into a long tradition of financial crises linked to the property cycle. For example, Bank of England data show that the UK CRE market has experienced five distinct boom-bust cycles in the last century, characterised by average peak-to-trough price falls of 26%.[11] The impact on the health of the banking system was very clear in the recent crisis. Some of those exposed to the relatively modest part of the European CRE debt market that had been securitised also suffered.

There is an illusory simplicity to CRE lending: assessing and pricing the risk of a secured loan against an income producing physical asset with an inherent capital value is surely a more straightforward matter than lending to most other kinds of business. But CRE lending is a varied universe and can be anything from very risky to very safe. Over many cycles in many countries, neither banks nor their regulators have found effective ways of systematically assessing and managing CRE lending risk. Instead, they tend to go with the cycle, underestimating risk and flooding the CRE market with debt in a boom, and overestimating risk and starving the CRE market of credit after a crash.

Stopping the CRE cycle is neither possible nor necessary to protect financial stability; neither is restricting the attractiveness and viability of risk transmission mechanisms like securitisation. However, strengthening the financial system's ability to weather future CRE booms and busts requires a loosening of the link between the CRE cycle and the two different cycles that feed it:

- the pro-cyclical behaviour of banks and other lenders which feed the boom with loose lending, before exaggerating the bust by starving real estate businesses of credit; and

- the pro-cyclical behaviour of regulators, who tend to grow too relaxed about risk when markets are overheating and risk is objectively greatest, and become excessively risk averse after a crash when credit is most needed to support investment and risk is objectively lower.[12]

Building greater stability and counter-cyclical mechanisms into the financial and regulatory systems to decouple lending and regulatory cycles from the CRE cycle should also help the CRE sector and the wider economy. Rather than exacerbating the cyclical peaks and troughs through alternating excess liquidity and credit drought, lending institutions and their regulatory framework could instead provide a

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[10] Again, this issue is not peculiar to CMBS – it relates to the underlying CRE lending market, which is the level at which it needs to be tackled (for example, as recommended by *A Vision for Real Estate Finance in the UK*, referenced in footnote 1).

[11] See http://www.bankofengland.co.uk/publications/Documents/speeches/2013/speech701.pdf. The amplitude of the property cycle is perhaps three times greater than that of the business cycle.

[12] As Andrew Haldane (then Executive Director, Financial Stability) of the Bank of England put it in a speech at the American Economic Association Annual Meeting on 3 January 2014, the "*time-consistency dilemma*" facing macro-prudential regulators "*manifests as a desire to loosen regulation to support today's growth when tightening to counter tomorrow's crisis would be more appropriate*".

more consistent and sustainable flow of credit to CRE across the cycle. Furthermore, as improved stability reduces risk for lenders and borrowers, their required returns should fall, reducing the cost of both debt and equity capital for CRE investors and their customers and increasing investment to support wider economic growth.

Against that backdrop, CMBS should be part of the solution, because it can transmit risk around the financial system, allowing non-originating investors access to CRE debt and facilitating a broader range of loan products than originator balance sheets alone are likely to generate. The performance of CMBS during the crisis needs to be assessed not only relative to other ABS asset classes (which did better than CMBS), but relative to the wider CRE lending market. The most robust data we have seen is 2011 UK data, and indicates default rates of 7% in securitised CRE loans compared to 26% in unsecuritised CRE loans.[13] Looked at in that way, CMBS was one of the many victims of a cyclical fall in underwriting standards. Simpler structures, improved transparency and better documentation can all make future CMBS better – but the fundamental challenges lie in the underlying CRE lending market.

[13] This comparison (presented in Bank of America Merrill Lynch's *European CMBS 2012 Outlook and 2011 Review*, published 12 January 2012) also strongly suggests that poor alignment of interests has not been a factor in the performance of CMBS.

Appendix 2: Detailed responses to specific questions raised by the DP

Motivations
Q1. Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section2?
Yes, we agree. In particular, a well-functioning securitisation market has a vital role to play in reducing the traditional dominance of banks in the European CRE finance market, in the interests of promoting both capital flows to a critical enabling sector of the real economy, and financial stability. We are still living with the consequences of the fact that CRE finance has been heavily concentrated in the European banking system, where the resulting risks are opaque both for regulators and the market. While greater diversity in CRE loan origination (and indeed in equity ownership) is relatively easy to achieve in core, prime markets with large scale assets, the CRE investment market in smaller assets and regional assets is structurally reliant on domestic banks. A better-functioning CMBS market can improve competition and support financial stability by: (a) allowing non-originating investors to gain exposure not only to more liquid forms of CRE debt, but also, potentially, to smaller scale, SME, and regional parts of the market; (b) freeing CRE businesses (particularly smaller and regional ones) seeking debt from the constraints of the balance sheets and regulatory and commercial preferences of banks as regards the terms and pricing of loans available; (c) dispersing CRE debt risks around the financial system, away from systemically important banks; and (d) increasing CRE debt market transparency, as there is far better information both for the market and for regulators about the public CRE debt market represented by CMBS than there is about the rest of the CRE debt market, which is private and about which very limited good quality data are generally available. It is important to note that the benefits of a well-functioning CMBS market are needed not only at the high quality, low risk end of the market, but also for higher risk, higher return parts of the market. That is true both from the point of view of the real economy (smaller size and regional CRE loans would generally be regarded as higher risk, higher return, but the communities where the relevant CRE is located require investment just as major centres do), and from the point of view of CRE debt investors (who may want a diversified portfolio to include such exposures), and from the point of view of financial stability (do we really want to encourage banks to distribute low risk exposures while retaining higher risk exposures?). Accordingly, while we strongly support a principles-based approach for identifying simple, structurally robust and transparent securitisations, those characteristics should not be confused with risk and credit quality.
Barriers to a well-functioning securitisation market in the EU and economic of securitisation
Q2. After para 82: Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?
Yes, we agree. We would highlight the dangerously distortive impact that poorly designed regulation can have. For example, as we understand it, the proposed Solvency II regime would impose a total aggregate capital charge on an insurer holding a five year duration AAA CMBS bond of

62.5%, as compared to a charge of 15% for an unrated five year duration whole loan; or less than 4% for a five year duration covered bond; or 25% for direct ownership of the actual real estate; or 39% (listed) or 49% (private) for a non-look-through investment in a company or fund that itself has an equity or debt exposure to the real estate. The relative position of the safest CMBS bonds in that structure seems to us quite impossible to justify – but the message it sends to insurers seeking CRE and/or CRE debt exposure is very clear: buying CMBS is the worst way to do it. That is despite the liquidity and risk diversification benefits that CMBS can offer insurers as compared to whole loan origination. From a broader investor perspective, taking insurers out of the CMBS market can only reduce the size and liquidity of the market for others, including asset managers without the ability to set up their own origination platforms. We understand that the risk retention rule raises compliance costs for private funds, which are highly sensitive to expenses, especially in a low interest rate environment. Even these relatively modest costs can skew the risk/reward profile of an asset class and dissuade market participants from investing in a particular type of security. An additional impediment for investors in ABS (including CMBS) are higher operational requirements compared with other asset classes. This includes due diligence requirements which, while proper in themselves, penalise securitisation on a relative basis when viewed in the round alongside capital charges. Well-informed and sophisticated investors willing to invest in the systems and expertise required are penalised by higher capital charges compared with other asset classes that have lower operational requirements. On sovereign rating caps, we think that rating agencies are transparent enough that investors usually know what the rating would be absent the cap. However, investors will be penalised for investing in ABS subject to rating caps because capital requirements are based on the capped rating and not on the underlying uncapped rating. In other words, the problem arises because of the regulatory capital rules, not rating caps per se, which rating agencies can explain.
Q3. After para 92: Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?
Yes, we agree. Higher issuer operational costs for ABS (relative to other funding instruments), as a result of higher transparency requirements etc. (however reasonable and appropriate these may be) are also a consideration.
Q4. After para 94: Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?
Yes, we agree. Market liquidity will of course also suffer if many ABS are ineligible for treatment as liquid assets. Higher capital charges and operational requirements for bank trading desks are also likely to increase bid/offer spreads. The US CMBS market returned due largely to two factors. First, issuers, servicers and investors worked together to make substantive improvements in industry standards and disclosure practices. Secondly, the Federal Reserve Bank of New York established the Term Asset Backed Securities Facility, which injected liquidity back into the system at the weakest point in the cycle. Today, participants in the US generally agree that current CMBS volumes are healthy, though they stand at roughly one third of peak issuance. The industry dialogue and short-term government support

resulted in a return to reasonable levels of market liquidity. It is here that the relatively idiosyncratic nature of CMBS is a benefit and not a weakness. Unlike the variously systemically important residential mortgage market, and despite the systemic significance of CRE as an asset class, CMBS is unlikely ever to grow to such a scale as to pose broad risks to the financial sector. Because investing in the asset class requires some level of fundamental analysis, its optimal scale is smaller than that of other markets (albeit much larger than its current size in Europe). At the same time, CMBS growth is a reasonable policy goal for all the reasons outlined in the DP, including providing support for SMEs (indirectly, in this case) and building financial system resilience through diversification.
Policy Options
Q5. After para 102: The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?
We agree with the analysis in paras 96 to 102, with the principles-based approach and with most of the principles included in Box 3. However, we have a number of general and more specific comments. At a general level, and as noted in our response to Q1, it is important to remember that the benefits of a well-functioning CMBS market are needed not only at the high quality, low risk end of the market, but also for higher risk, higher return parts of the market. That is true both from the point of view of the real economy (smaller size and regional CRE loans would generally be regarded as higher risk, higher return, but the communities where the relevant CRE is located require investment just as major centres do), and from the point of view of CRE debt investors (who may want a diversified portfolio to include such exposures), and from the point of view of financial stability (do we really want to encourage banks to distribute low risk exposures while retaining higher risk exposures?). Accordingly, while we strongly support a principles-based approach for identifying simple, structurally robust and transparent securitisations, those characteristics should not be confused with risk and credit quality. We have set out our detailed comments on the principles included in Box 3 in our response to Q18.
Q6. After para 103: Do respondents think that a liquid market for 'qualifying securitisations' available for funding would benefit from a 'qualifying certification'?
The answer to this question depends on precisely how 'qualifying securitisation' is defined. A poorly designed 'high quality' label which distorts capital allocation and flows and discriminates against whole sectors of the economy risks causing considerable damage. On the other hand, a well-designed and correctly calibrated 'qualifying securitisation' certification could certainly help promote liquidity (as well as other benefits) in securitisation markets. Existing CMBS investors probably don't need a quality label, basing their investment decisions on their due diligence, expertise and analysis, and aided by regulatory changes already in place. However, a certification specifically and explicitly intended to encourage good market practice in the use and structuring of securitisations would build confidence among a broader pool of potential investors. Ultimately, the greatest value of a 'qualifying securitisation' label would arise from the better regulatory treatment that might result – compared to the effectively punitive and prohibitive treatment (relative to other broadly comparable investments) currently threatening some ABS

(including all of CMBS, for example under Solvency II).

Q7. After para 104: These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?

We would distinguish between quality controls and risk at the level of underlying loans and at the level of the securitisation structuring. In the CRE debt context, the really important issues are in our view at the level of the underlying loans.

- The poor performance of some pre-crisis CMBS relative to other ABS asset classes was principally the result of poor underwriting standards in the underlying loans. The evidence[14] suggests that CMBS performance was good compared to the wider CRE debt universe. 2011 data from the relatively data-rich UK (where banks had at that time recognised losses in, but not yet made large disposals from, their retained CRE loan books) show that default rates of 7% in securitised CRE loans compare favourably with default rates of 26% in unsecuritised CRE loans. Viewed in that way, CMBS is plainly not a product to discard, but rather one to improve, so that investors in the bonds are effectively protected from any losses in the underlying loans. That is happening, for example through more subordination in response to risks at the underlying loan level, and longer tail periods between loan maturity and bond maturity to mitigate refinancing risk.

- It is vital that the principles for designating 'qualifying securitisations' do not in effect act as a blanket exclusion for entire asset classes. That would be the effect in the CRE context of a requirement for all underlying receivables to be self-liquidating, because CRE loans (whether securitised or not, and whether benefiting from any amortisation or not) usually have a balloon payment at maturity. For CRE debt securitisations, it would be better to define eligibility characteristics for the underlying loans – for example by reference to an appropriate LTV measure, coverage levels, and tail periods between loan and bond maturity. That is the sort of approach adopted in the US for identifying "qualifying commercial real estate loans". Such an approach would recognise that the problems experienced by CMBS in recent years were a function of problems in the wider CRE debt market, which the securitisation process could do more to mitigate, but certainly did not exaggerate.

- The CRE debt market cannot realistically function based on amortisation schedules that are shorter than 25 years – and does not need to do so, as land and buildings do not suffer complete loss of liquidity and value (other than, in extreme cases, for short periods). Further, it would be a mistake to derive confidence from the fact that a CRE loan fully amortises over a 25 or 30 year period. Most buildings would require capital expenditure to maintain rental value over such a long period, and the few leases that are that long are largely limited to government type tenants. As a result, full amortisation might seem to address refinancing risk, but can only do so by greatly increasing cash flow uncertainty. A five to seven year loan may be much easier to analyse and present a lower overall risk if it is advanced at a sensible LTV[15] and/or with a modest level of scheduled amortisation.

[14] Bank of America Merrill Lynch research, cited in footnote 13 above.

[15] How LTV is calculated is important here. LTV by reference to point-in-time value at origination is a commonly cited measure, but it is not a reliable indicator of refinancing risk. An alternative is exit LTV, which takes scheduled amortisation into account. Probably the best measure for risk management purposes is LTV calculated by reference to a cycle-insensitive, long-term fundamental or investment value. The rating agencies have their own methodologies for determining LTV in such a way, and this is also the recommendation put forward in *A Vision for Real Estate Finance in the UK* (referenced in footnote 1).

• There were also problems with the way CMBS transactions were put together, with legal documentation that sometimes failed adequately to anticipate the practical challenges that in fact arose. Had the underlying loans performed, these problems may not have become apparent. The industry has been working to address them, including through initiatives such as CREFC Europe's work on CMBS 2.0[16]. See *A Vision for Real Estate Finance in the UK*[17] for considered industry recommendations about how the underlying CRE lending market might be improved. That report's focus is on promoting financial system resilience and reducing feedback loops between CRE, credit and regulatory cycles, but its recommendations would also promote healthier CRE lending markets for the benefit of market participants and equity and debt investors. Specifically in the CRE debt / CMBS context, therefore, we believe that the industry could go a long way to address performance issues by developing eligibility criteria or quality controls for the underlying loans. At the same time, we would welcome sensible, well-designed and appropriately calibrated principles that effectively set best practice requirements for simple, structurally robust and transparent securitisation. Subject to the points made elsewhere about the risks of distortion and harm to the real economy and financial stability from a poorly designed 'qualifying securitisation' label, the main potential risk we see is that investors might come to rely blindly on a 'qualifying securitisation' label in the way that some have done on external ratings, and fail to conduct appropriate due diligence. Ensuring that the 'qualifying securitisation' label is explicitly and specifically designed only to set standards that allow investors to assess risk (without inappropriately discriminating against specialist asset classes like CMBS), would be the best way to address that risk.
Q8. After para 107: Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?
We strongly support, and indeed promote, efforts to improve information and transparency in relation to CMBS and CRE debt markets. The use of common standards where possible is helpful both for those collecting data, and for those (in the market and at the regulator) using the data. In the CRE debt context, information relating to CMBS and the loans underpinning CMBS issuance is generally good, especially when compared to the broader CRE debt market, which is private and opaque. CREFC Europe has created a reporting package (the European Investor Reporting Package, or **E-IRP**) with the involvement of investors, loan servicers and originators to operate as the market standard for CMBS bond, loan and property level information. The primary objective is to promote transparency, liquidity and ultimately growth in the CMBS market. The E-IRP has been used as the starting point for their own CMBS data requirements by the Bank of England and the European Central Bank's data warehouse – both central banks recognising that it made sense to build on the existing industry standard. There is scope to promote broader use of E-IRP across the European CMBS market (mirroring the very broad use of the equivalent investor reporting package in the United States). The E-IRP could

[16] See http://www.crefc.org/uploadedFiles/CMSA_Site_Home/Global/CMSA-Europe/Committees/European_CMBS_20_Committee/Market_Principles_for_Issuing_European_CMBS2.pdf, available at http://www.crefc.org/eucmbs20/.

[17] Referenced in footnote 1.

also be used as a starting point for the development of CRE loan information repositories for the wider, private CRE debt market, such as has been recommended in *A Vision for Real Estate Finance in the UK.*[18]
Q9. After para 110: Do respondents think that initiatives currently undertaken by authorities in this domain are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?
There is generally room for improving both access to, and comparability and consistency of, information for investors. However, it is important that decisions in this area be informed by (or even driven by) industry dialogue, to avoid the imposition of reporting requirements that fail any reasonable cost/benefit test.
Q10. After para 115: Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?
Please see our response to Q8 and Q7. We believe that a loans database which is publicly accessible (subject to minimum aggregation to preserve the confidentiality of individual lenders, borrowers and assets) would be a positive development for CRE debt markets generally. We agree with the reasoning set out in *A Vision for Real Estate Finance in the UK* (see Recommendation 1).[19] Specifically as regards CRE debt securitisation, imposing a requirement for sensible data collection and submission in relation to all CRE lending would significantly reduce one of the relative costs historically associated with CMBS, namely the reporting requirements associated with securitisation. It is important to recognise that the CRE loan (and property) level information currently available to investors in European CMBS, while not perfect, is generally far better than the information available in relation to unsecured CRE loans (and property) or in relation to CRE-backed covered bonds.
Q11. After para 115: In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for [high-quality] securitisation?
We generally support these suggestions and refer you to earlier responses. In particular, we would like to see wider use of the E-IRP reporting framework for CMBS (and perhaps of a simplified version of E-IRP adapted for the purpose in relation to non-securitised CRE loans).
Q12. After para 116: Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be most useful and which could be easily produced?
Developing benchmark indices would be more challenging in the context of the CRE debt market than in debt markets that are larger and more homogeneous. An additional challenge is the lack of

[18] That report is referenced in footnote 1 and is also discussed in the Bank of England's Discussion Paper of 29 May 2014, *Should the availability of UK credit data be improved?* (itself referred to in para 112 and footnote 10 of the present DP).

[19] Referenced in footnote 1.

credit and performance data in CRE debt markets, which (with the exception of CRE debt that has been securitised) remain opaque. We support proposals for better public data in CRE debt markets, such as the recommendation for a loans database proposed in *A Vision for Real Estate Finance in the UK* and referred to in the Bank of England's Discussion Paper on improving the availability of UK credit data (see footnotes 1 and 18).
Q13. After para 117: Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?
We agree that this would be very helpful and should facilitate sensible use of securitisation in countries with lower sovereign ratings.
Q14. After para 123: How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?
We would supplement the discussion and suggestions in the DP as follows. Any CMBS transaction seeking an AAA credit rating will be required by the rating agencies to feature a liquidity facility to cover short-term disruptions or delays in cash flows. Historically, these facilities received beneficial regulatory capital treatment, which recognised the minimal credit risk they entailed as a result of their super-senior payment priority (ahead of the AAA rated securities themselves). Changes to the regulatory capital treatment of such liquidity facilities under Basel III require liquidity facility providers to maintain substantially higher levels of capital. This has caused many potential providers to withdraw entirely from the market, and significantly higher margins are being charged by the few remaining lenders. At the same time, as the duration of CMBS securities is increasing (due at least in part to the move to longer tail periods between loan and bond maturity, discussed elsewhere in this submission), liquidity facilities are required for longer, so the increased costs associated with them matter more. The lack of affordable liquidity facilities seems likely to limit the issuance of CMBS in the future and will somewhat arbitrarily limit the pricing advantage that capital markets finance should provide. A number of recent European CMBS transactions have been issued without a rating, because of the difficulty of putting in place the liquidity facilities rating agencies require at an affordable price. That trend seems unfortunate. We do not believe that the risks associated with the provision of a properly structured liquidity facility supporting AAA securitisation bonds are such as to justify the higher capital charges imposed on them. We would encourage consideration of targeted exemptions so that the sensible use in securitisations of liquidity facilities is not compromised unnecessarily.
Broader questions
Q15. After discussion of policy options: With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?
We have explained in Appendix 1 and more generally in this submission that CRE is an inherently

lumpy and heterogeneous asset class which to some extent inevitably feed through to the loans that are made against it. CRE debt cannot be approached in a similar way to most other ABS asset classes – but it is at least as important in terms of its function in the economy. Regulators also need to be mindful of the fact that the financial stability challenges connected with CRE markets are a function of the wider, overwhelmingly private and opaque, CRE lending market. We applaud and support industry efforts, and collaboration with policymakers, to address those challenges. CMBS is part of the solution, not part of the problem. While greater transparency and a degree of standardisation have a vital role to play in creating a healthier, more diverse and stable CRE debt market, there are limits to what can sensibly be achieved, set by the nature of land and commercial buildings. Insisting on granularity or full amortisation in the CRE debt context is like asking cyclists to wear parachutes. You need to understand the nature and risks of cycling before you defining the appropriate protection. Refinancing risk is a structural feature of the CRE debt market linked to the nature of commercial buildings and the businesses that own them – it cannot realistically be eliminated altogether, and any 'qualifying securitisation' label needs to acknowledge that reality. Do regulators simply want to ensure that refinancing risk remains in originating banks?
Q16. After discussion of policy options: Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?
From the point of view of CRE and CMBS, policymakers should encourage implementation of the recommendations in *A Vision for Real Estate Finance in the UK*[20] to improve both the structure and nature of the CRE debt market and industry and the regulatory framework that applies to it. While those recommendations are focused on the UK, there is much that could valuably be implemented internationally; and while the recommendations focus on CRE debt markets rather than securitisation, their implementation would address many of the problems that have affected CMBS. Regulators should also continue to support industry initiatives to develop, improve and disseminate best practice standards and, to the extent possible in particular contexts, standardisation of documentation and terminology (at the underlying loan level as well as in securitisation documentation).
Q17. Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?
We refer you to our answer to Q16. We do not see any particular risks associated with the suggestions we make there.
Box 3
18. Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?
We have discussed our main concerns elsewhere in this submission. Specifically by reference to the proposed principles set out in Box 3: ***Para 124 (evidence of relative performance)***: We can see a tension between this para and the points

[20] Referenced in footnote 1.

made in para 126 (with which we agree) about the aims of the proposed principles. It is important not to be distracted by performance during the crisis, and to ensure that reference points and comparisons are meaningful and relevant. Some CMBS performed poorly relative to other ABS, but chiefly that was because of underlying underwriting standards which affected balance sheet lending by banks in the same way – it was not the result of securitisation structuring. That can be seen from the fact that the performance of loans in CMBS relative to the much bigger CRE loan market was good (as noted above). It is important to remember that "modelling risk with confidence", as mentioned by para 126, need not be (and in the CRE/CMBS context, generally should not be) a statistical exercise: it may very appropriately instead involve asset-by-asset due diligence.

Para 129 (Underlying asset performance history): As noted above, verifying asset performance history needs to be approached differently in the CRE debt context – so much depends on individual buildings, leasing positions, and a range of objective and subjective factors that in most cases the important thing is access to information and the opportunity to conduct asset specific due diligence. The key is not granular data that might allow statistical analysis.

Para 131 (Expectation of payment): We think that this requirement is inappropriate and unnecessary for CMBS. Unless the underlying portfolio is very granular and more akin to an SME ABS transaction, the originators of large-loan CMBS securitisations will not necessarily have a large number of similar loans on the balance sheet, and data relating to any such business would in any event be of doubtful value for investors conducting their due diligence. The heterogeneity and 'lumpiness' of CRE means that greater transparency to the loans and the real estate underpinning the CMBS issue in question is much more valuable for investors seeking to assess risk than data relating to a wider CRE lending business. Accordingly, we do not believe that para 131 is necessary or useful for CMBS (any more than it would be for corporate bonds, for example). To the extent that this proposed principle is intended to promote better alignment of interests, as explained above, the evidence suggests that misalignment of interests has not been a problem in the CRE/CMBS context; and to the extent that it may be, risk retention should be adequate to address it.

Para 132 (Current and self-liquidating):

As explained above (see in particular our response to Q7), the CRE lending market is not a fully amortising market, for good reason – in the large majority of cases, full amortisation is neither commercially feasible nor necessary (or reliable) to address refinancing risk. Fully amortisation over a typical five year loan term would be deeply unattractive for borrowers; and banks (a vital class of lender and historically the overwhelmingly dominant one in Europe) are strongly disincentivised, for perfectly sensible reasons, for lending at longer maturities. Most strong borrowers with good quality assets would in any event resist pressure for fully amortising loans, creating adverse selection risk for securitisable CRE debt.

Imposing a self-liquidating requirement for CMBS to benefit from 'qualifying securitisation' status would in effect exclude CRE debt from securitisation markets. That would represent a missed opportunity to promote financial system (and property economy) resilience through greater diversification (of lenders and products). It would do nothing to address refinancing risk in the CRE debt market, while making it harder for that risk to be dispersed beyond the banking system. It would also make it more difficult for non-originating investors to gain relatively transparent, diversified and liquid exposure to CRE debt risk and returns; as well as limiting the amount and the choice of debt products available to property businesses wishing to invest in the built environment. It would also discourage and disempower industry efforts to address past weaknesses in the CMBS and wider CRE debt markets.

Refinancing risk plainly does exist in CRE debt markets, and it is discussed extensively in *A Vision for Real Estate Finance in the UK*.[21] That Group's most targeted recommendation for addressing it is the proposal that regulated lenders should use a cycle-insensitive long-term value measure when calculating LTV for risk management purposes, with capital charges linked to that LTV calculation rather than to one based on point-in-time market value. This suggestion is not revolutionary: Germany's *Beleihungswert* concept and the rating agencies' own calculations of LTV when rating CMBS bonds follow a similar logic. This solution seeks to moderate the feedback loops between CRE, credit and regulatory cycles and to reduce overall risk in the financial system. A full amortisation requirement in the 'qualifying securitisation' definition, while simpler, would not have those effects.

When CRE debt is securitised, refinancing risk is mitigated – even if that mitigation was not sufficient in all pre-crisis CMBS issues. The rating agencies are already increasing the protection they require to address it, for example by lengthening the tail periods between loan maturity and bond maturity. Promoting practical and effective mechanisms for disclosing and managing refinancing risk for bond investors would support more effective mitigation of refinancing risk in CRE debt markets. Classifying CRE loans that do not fully amortise as automatically non-'qualifying' would not.

It is perfectly possible for analysts, rating agencies and investors to assess refinancing risk, given adequate information. The use of a credible and consistent through-the-cycle value in LTV calculations for risk management and capital purposes would be helpful in that regard. Land and buildings generally have a fundamental investment value that does not disappear, and a moderate level of debt at loan maturity will almost always be refinanceable before the end of a reasonable tail period to bond maturity. That can be achieved through a sensible LTV at origination, or an appropriate amount of scheduled amortisation during the life of the loan, or a combination of the two. Alternatively, there may be value in considering the the US definition for "qualifying commercial real estate loans" in the context of the risk retention rules. This sort of approach would be entirely compatible with the aims behind the proposed principles, and the principles should be amended accordingly.[22]

[21] Referenced in footnote 1.

[22] We have not been able, during the time available, to model particular combinations of LTV (with particular approaches to defining "V"), scheduled amortisation and tail periods against CRE market cycles so as to determine what appropriate levels would be, but we are confident that could and should be done to derive a more pragmatic and effective principle than para 132 in its current form.

Some Comments on Securitisation: June 28, 2014

I am an American private investor with a large diversified portfolio of listed equities that includes several large European banks, which were purchased just after Mr. Draghi made his famous London speech in the summer of 2012. I own no bonds, or derivatives of any kind. I too am troubled by the tightness of credit, and lack of growth, of SME lending, which has been evident for some time, and welcome your interest in its alleviation.

Your list of impediments to be overcome, including the tarnished reputation of the securitization as well as constraints imposed by regulatory capital charges and rating agency opinions, including sovereign debt rating 'caps', convinces me that an active securitization market is not likely to be forthcoming anytime soon. You also point to the paucity of data on SME loans and suggest ways this lacunae might be overcome, but not without expense from additional layers of infrastructure and due diligence.

What you seem reluctant to acknowledge is that the quality or 'riskiness' of SME loans cannot be ascertained by assembling current or historical data, or by modeling. The 'riskiness' of an SME loan is unquantifiable; SME's dwell in a realm of risk that Frank Knight defined as 'uncertainty'. At bottom, the 'riskiness' of a loan to a SME depends on qualitative rather than numerical considerations: the character, the reputation, and even the health of an individual entrepreneur or a small team of partners, as well as a thorough understanding of the collateral pledged, and the business model of the enterprise, whose success may depend on catering to only a few major customers. The success of a non-public SME may also depend in part on the confidentiality of its financial and other business connections and arrangements, as you have implied. Readily available, timely, reliable public qualitative data does not and never will exist. In short, thorough quality credit analysis of SME loans cannot be done from afar. After 2008, any potential buyer of a securitised loan is now well aware of this and will not accept without suspicion the opinions of any at-a-distance authority. Any attempt to gain the market's confidence by a second layer of data-based credit analysis by a rating agency or any other organization is a pointless expense and will fail.

If quality credit analysis of SME loans can be done only by those with direct contact and knowledge of the prospective borrower and his business, we must ask on what basis do the authorities in far away Basel judge SME loans to be 'risky'. Thousands of heterogeneous SME loans certainly do not present a system risk. No one to my knowledge claims that it was poor underwriting in SME loan books that created the financial crisis of 2007-8, although many SME loans later became bad as a result of the economic downturn. In the Euro area bank credit for SME's tightened in the 'periphery' because of fears of a Eurozone breakup, which also caused SME loan losses. The major cause of the financial crash was the poor, even fraudulent underwriting of mortgages and faulty credit ratings on securitisation and credit default swaps. The classic moral hazards of risk transfer were ignored.

We should ask why SME loans warrant a relatively high capital charge (which in effect is an unlegislated differential tax on the SME lender and SME borrower) compared to holdings of sovereign debt? The greater part of sovereign tax revenues derive from the success of SME businesses and the income of their employees. The prosperity of the sovereign and the prosperity of its SME's in a sense is one and the same. While the riskiness of individual SME loans is obvious, the risk in a diversified book of heterogeneous SME loans may not be high, especially if the loans are spread geographically. The record of SME loan losses in Germany bears this out.

Instead of trying to get around the bank capital rules of Basel regulators by attempting to hurdle the innumerable impediments of starting up a securitization market for SME loans, effort should be directed at reducing, or even eliminating the differential capital charge (tax) on SME loans which discourages lending to SME's, especially at a time of rising overall capital requirements.

Sincerely,

David K. Richards
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4 July 2014

Re: The case for a better functioning securitisation market in the European Union

Dear Sirs,

The Deloitte International Securitisation Team[i] welcomes the opportunity to respond to the questions set forth by the Bank of England and the European Central Bank (hereafter referred to as the "Banks") in their discussion paper, "The case for a better functioning securitisation market in the European Union".

Our response is given in the context of our role in the European securitisation market where we provide a range of services, from assisting clients as they prepare for securitisation, through the provision of support through the execution of the transaction and beyond. Whilst we are therefore not market participants as such (we are neither issuers of securitisation paper nor investors) we do believe that one of our roles is to assist clients, regulators and other stakeholders to gain an understanding of securitisation, its benefits and challenges, and to help the industry develop standards that promote a more transparent and stable market.

We have organised our response around the four basic sections of your paper: the present state of the market, the concept of a qualifying securitisation, convergence of software and data availability, and policy.

I. Present state of the market

We agree that securitisation is an excellent funding tool for the real economy; it is a flexible funding solution that can be tailored to match both the needs of issuers and investors. It has the potential to increase the available investor base seeking asset exposure by using structure to segregate the various risks embedded in the assets (credit risk, maturity timing and interest rate direction) and allocates such risks to different investors with distinct risk appetites. In a well-functioning market, this allows an originator of assets to allocate much of the risk embedded in the assets to other investors at a reasonable profit.

It is clear that the recent regulations enacted in the EU have impacted the prudential treatment of securitisations in terms of:

- Alignment of incentives between originators and investors;
- Reduction of mechanistic reliance on external ratings;
- Measures to increase transparency;
- Adequate control of credit rating agencies;
- Increased capital requirements

We also acknowledge that there are other pending policy measures that will affect the regulatory treatment of securitised instruments from an issuer and investor perspective going forward.

In our experience, for a high quality securitisation, care must be given to both the origination/sourcing of assets as well as in developing the structure. We believe regulators have made excellent strides in ensuring the quality of assets to be securitised and in promoting transparency and disclosure. We remain concerned that given the number of regulators (and consequently, regulations) all with unique mandates, that banks and other risk-based capital sponsors of securitisations face uncertainty when determining, (i) the capital needed to support future securitisation programmes, and (ii) when they will know the full complement of pertinent regulations they must meet to participate in a securitisation. We also remain very concerned that risk rates for securitised products that are neither a re-securitisation or backed by synthetic assets remains high relative to other assets of comparable risk. This concerns us as we know such imbalance leads market participants to over participate in markets that have a lower cost per capital and under participate in those with a higher cost, creating imbalances in the financial system.

We believe the paper identifies the majority of impediments to the market as well as economic concerns of issuers: regulatory uncertainty, lack of uniformity across regulatory regimes, and new derivative regimes, some of which do not address the types of interest rate and currency derivatives used in securitisations. We are less concerned with infrastructure needs as we see many market participants addressing the software and data needs of investors and competing to provide solutions. We welcome investors ongoing focus on due diligence and review as we believe investor discipline is key to a well-functioning market.

We do not believe market liquidity to be a barrier. A securitisation, by virtue of its structure, will always have liquid classes and illiquid classes. Rather, we see the current lack of liquidity due more to regulatory uncertainty – the institutional investor base that invests in securitisations must currently tread very carefully as the risk weights, as well as the required processes and procedures they must embrace to participate in the market are as yet being determined.

II. Concept of a "qualifying securitisation"

The view of the Banks is that a "qualifying securitisation" should be defined as a security where risk and pay-offs can be consistently and predictably understood. While the assets underlying a securitisation have defined, contractual money terms that are consistent throughout the term of the asset and can be easily modelled, the behaviour of the borrower is not so predictable. Borrowers have choices. We believe what makes securitisation securities unique is that one must understand both the contractual terms of the underlying assets and created securities as well as the impact different human behaviour can have on such contractual structures. These concerns would have us phrase the definition a bit differently as we believe investors should know that only they can be responsible for assessing what they think borrowers' behaviour will be.

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In the main, we believe the principles in Box 3 are sensible and an excellent base to start with. Of concern is some of the loan level data requested. First, we are not sure how new or first time issuers will be able to provide "verifiable loan loss performance" … "for a sufficient time period of at least the effective life cycle of the receivables and covering at least one period of significant market stress". Would a new originator of SME loans with a 7 year term have to wait both 7 years and through the next crisis in order to comply? Second, it has become clear to market participants that we need to develop ways to provide sufficient loan level data to institutional investors in a way that does not violate or put at risk the privacy of the underlying borrowers. It has become abundantly clear to market participants that technology has moved apace since the crisis and it is becoming increasingly difficult to protect borrower's personal information to prevent identity theft and fraud – in fact the industry in now focused on how the criminal element can marry data from various sources to attack individual borrowers' financial security. A similar argument can also be applied to information that is commercially sensitive to institutions.

An important consideration is whether the "qualifying securitisation" concept is a designation made only at issuance or something which requires ongoing assessment. If it were to be a designation at issuance would there conceivably be events, such as a restructuring of the transaction, which could lead to the removal of the designation?

Clearly, continual assessment could mean that performance deterioration resulted in the designation being removed. There are several questions that arise if this were the case:

- Who would monitor/police compliance with the standard?
- What would be the frequency of any monitoring, would this be an annual event, every interest payment date or at some other regular interval?
- What would the costs be?

There could also be un-intended consequences of this approach such as investors having to do a 'forced sale' if qualifying securitisations form part of their mandate. Additionally, would only certain tranches in a transaction be deemed qualifying or would the entire transaction be qualifying (and therefore affect all tranches in a deal)?

The Banks also ask if market participants believe the appropriate authorities could play a role in the "process of certifying that a transaction is a 'qualifying securitisation'". Of concern is the number of appropriate authorities, especially given the global nature of the investor base. What if there are several regulators and they have yet to build a consensus? Securitisation is a very dynamic market. What we do believe market participants would find very helpful is if the various regulators could form a working group to answer queries that emerge as market participants work with the new regulations. Whether this would be a working group, a web portal to collect questions and responses or a combination of various communication means is not clear to the market. We ask that regulators ponder mechanisms that work best for them so that such a mechanism can be created. We suggest that the regulatory authorities identify an appropriate outlet for these types of questions, through working groups, Q&A databases, or otherwise.

We also note the principles in Box 3 include that "the initial and ongoing terms and reports for the securitisation should be reviewed by an authorised accounting practice or the Calculation Agent of the transaction". In our experience the Calculation Agent typically holds several other roles (such as trustee, collateral administrator, etc.,) and often one of those roles involves preparing the ongoing reports. We believe that an authorised third party (which could be an accounting practice) should be required to "tie-out" with the sponsor for numerical disclosures made pursuant to the Prospectus Directive and with the trustee/Calculation Agent for many of the numerical disclosures made in payment date reporting. In our experience having an independent party tie-out with the preparer of such reports increases the accuracy and quality of such reports.

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Lastly, we remain concerned about the liquidity of existing ABS securities. What will be the impact of qualifying securitisations on legacy transactions? Could legacy transactions become "qualifying securitisations" if their on-going reporting and underlying structure meets established standards? Could qualifying securitisations include securitisations from other regulatory regimes that are "qualifying" for their jurisdiction but may not meet the exact criteria of the Banks' qualifying securitisations?

III. Software convergence and data

We do not believe that the Banks or other regulators need to be overly concerned with developing further harmonisation and conversion software. Currently the industry is served by many software and data providers and they are all very aware of the changing regulatory environment their clients face and are currently developing competitive solutions. As their clients need systems that can interface with many other systems, they are very adept at conversions and solutions that allow their clients to move data from one system to another. Standardisation is always helpful so long as it does not preclude data crucial to one asset type and not another from being disclosed. As stated above, the greatest risk in providing loan level data to institutional investors is the issue of "personally identifiable information" – and the risk disclosing such data brings to the consumer/borrower.

IV. Policy

We ask that the Banks remain mindful of the risk of regulatory arbitrage, the risk that by providing incentive for market participants in one area creates a scarcity in another area and an over-participation in the incentivised market. Currently, covered bond transactions are treated more favourably than other securitisations though they share similar principles. Securitisation, done correctly with the right incentives, is a viable tool that creates excellent investments for institutional investors; investments that can end up in consumers' pension and insurance funds.

V. Conclusion

In conclusion, we welcome the Banks approach in the paper and look forward to further discussions with the Banks. We would like to assist in the efforts of developing a "qualifying securitisation", especially in the areas of standardising disclosure and ensuring numerical disclosures have been adequately reviewed.

Yours faithfully,

Deloitte LLP

Deloitte LLP

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[i] The Deloitte International Securitisation Team is a group of Deloitte professionals from across the Deloitte global network focused on providing accounting and modelling services to sponsors and investors in securitisations

Deutsche Bank

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Deutsche Bank's response to Bank of England (BoE) and the European Central Bank (ECB) joint discussion paper on "The case for a better functioning securitisation market in the European Union (EU)"

Dear Sir or Madam,

Deutsche Bank (DB) welcomes the opportunity to comment on the above discussion paper.

We strongly support the ECB and BoE initiative to restore securitisation markets and appreciate the role both institutions play in stimulating a comprehensive debate about the role of securitisation.

It is widely recognised that properly regulated securitisation can play an important role in supporting the economy. In order to address flaws around misaligned incentives, transparency and over-reliance on ratings, a number of regulatory measures have been implemented since the financial crisis. While there has been encouraging language from policymakers recently about revitalising securitisation, there remain considerable challenges in meeting their aspirations, in part due to some current and proposed regulations.

We see the following legislative proposals as key in impacting the viability of securitisation markets:

a) Future uncertainty around capital requirements for securitisations act to deter potential issuers and investors. It is highly important to ensure that the final calibration of the Basel revisions to the securitisation framework, the Fundamental Review of the Trading Book and Solvency II support the revival of securitisation;

b) Inconsistent implementation of risk retention requirements in key jurisdictions discourages, or even prevents, cross border trading; and

c) Disclosing information on private transactions risks discouraging origination and investment in this type of transactions with little benefit to the market, investors or borrowers.

Establishing principles for qualifying securitisations is a welcome step. Eligible securitisations must receive capital treatment commensurate with these reduced risks. As securitisation markets are global, we would encourage the ECB and BoE to also look at establishing the concept of qualifying securitisation in international fora such as the BCBS and IOSCO.

More detail on our views is provided in the annex. Please let us know if we can provide any further information.

Yours sincerely,

Daniel Trinder
Global Head of Regulatory Policy
Deutsche Bank

Annex I – Impediments to revival of securitisation markets

While there has been encouraging language from policymakers, there remain considerable regulatory challenges to the viability of securitisation:

a) Capital requirements

We welcome the proposed changes made by the Basel Committee to simplify the securitisation framework[1]. However, we remain concerned that the resulting capital charges for securitisation are a multiple of charges for the underlying portfolio pre-securitisation.

Left unchanged, the proposed rules would substantially reduce the incentives for banks to participate in securitisations and may have a considerable impact on the securitisation market and the availability of affordable credit to the wider economy.

In our view, the best way to calibrate the capital requirements would be to start from the point where the capital charge for the underlying pool and the capital charge for the securitisation are identical. As a second step, the calibration of the capital treatment of different tranches could include a suitable prudential buffer to address model risk and securitisation specific structural features. If the prudential add-on is disproportionately high, the proposed rules would have significant costs, not just for the viability of the securitisation business but also to the broader economy as the securitisation as a financing technique will be further discouraged.

Similarly the capital charges for securitisations held in the trading book, need to be calibrated in a way that does not discourage trading of securitisations. Unfortunately, the recent BCBS FRTB discussion paper proposed significant increases in risk weights for securitisation positions as well as inconsistent treatment and would result in materially higher capital compared to the latest proposals for the regulatory banking book. We hope that the BoE and ECB will ensure that the BCBS works to the same guiding principles at the international level that are being used at the EU level.

Calibration of both, banking book and trading book capital requirements for securitisations is due to be finalised in the coming months and will be of crucial importance to viability of securitisation markets, not just in Europe, but globally.

b) Risk retention

We recognise that risk retention rules are an important element of the regulatory framework to align incentives for investors and issuers as well as restoring the trust in the securitisation markets. Properly calibrated, they also have real potential to incentivise originators, issuers and investors to conduct quality screenings, improve underwriting standards and adequately monitor for credit risk.

For a vibrant and robust securitisation markets, it is crucial to minimise regulatory inconsistencies. It is therefore important to ensure a level playing field between major jurisdictions originating and trading securitisations. Where risk retention rules serve the same objective of aligning incentives between investors and issuers, mutual recognition of risk retention rules should be granted. Reference is specifically made to the proposed joint rule of the six Federal U.S. agencies on credit risk retention of 28 August 2013 which will define the standards for risk retention applicable to the world's largest securitisation market.

We would also comment that retention requirements for qualifying securitisations, may not be required given that: (i) investors are already subject to onerous due diligence requirements before entering into securitisation transactions; (ii) issuers are already subject to significant disclosure obligations under relevant public securities laws (e.g., the Prospectus Directive); and (iii) the types of transactions and

[1] http://www.bis.org/publ/bcbs269.pdf

level of transparency relating to qualifying securitisations means that such transactions should perform exactly as they are described and understood. This means there is no longer any misalignment of interests and that any residual retention requirement would simply serve to reduce the effectiveness of the securitisation market. This is the proposed approach taken by the U.S. authorities which waives the retention requirement for securitisation of qualified residential mortgages (QRMs) and certain other asset classes like commercial real estate (CRE), commercial loans and automobile loans.

c) Onerous disclosure requirements (i.e., Regulation (EU) No 462/2013)

According to Article 8b of Regulation (EC) No 1060/2009 on credit rating agencies (as introduced by Regulation (EU) No 462/2013) all structured finance instruments (SFIs) are to be subject to disclosure requirements, regardless of whether the deal is public – private and bilateral transactions are explicitly in scope and regardless of whether the deal has a credit rating – unrated transactions are also explicitly in scope.

Subjecting private deals to disclosure requirement would have a negative effect on this portion of the securitisation market with no obvious benefit to the market, investors or borrowers/originators.

We therefore welcome European Securities and Markets Authority (ESMA) decision to work on a special disclosure template to accommodate the specific nature of the private deals. Private securitisation transactions represent core bank lending facilities similar to the providing of corporate loans. They help relatively new and fast growing sectors to obtain funding without having to disclose sensitive information to the public.

Article 409 of Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (CRR) provides for the correct level of disclosure to private investors without disclosing sensitive information to the public that would make these deals unattractive to the investor and hence undermine securitistion issuance.

The benefits of extending disclosure on private deals from potential investors who sign confidentiality agreements (as under CRR) to the public are unclear. The risks however, are pronounced. Disclosing information on private deals may hurt lending to the overall economy as these facilities often support funding to sectors, industries and jurisdictions where traditional bank lending is restricted or reduced (for example lending to corporates and consumers, or entities which emerge from bankruptcy proceedings).

Annex II - Qualifying Securitisations

Overarching views

Principles for a qualifying securitisation could be a powerful way to help start and sustain a stronger securitisation market. Securitisations which meet all the eligibility requirements should receive treatment commensurate with reduced risks, in contrast to the currently-proposed “catch all” regulatory treatment for all asset-backed securities (ABS). To meet the stated objectives, the eligibility criteria would need to be sufficiently broad in terms of sectors included (ABS, residential mortgage-backed security (RMBS), auto loans, commercial real estate mortgages, leveraged loan collateralized loan obligations (CLOs) and commercial mortgage-backed securities (CMBS). Only this way it will be of real benefit to the market.

The paper does not indicate <u>when</u> the criteria for a qualifying securitisation should be fulfilled in order to classify a securitisation as ”qualifying”, i.e. whether they must be fulfilled at a specific point in time (e.g., at trade inception or at the beginning of the investment) or on an ongoing basis. It should be clarified that the criteria must be checked and fulfilled at the time when the bank invests in the securitisation provided that the underlying pool is static. The same holds true for revolving securitisations (where exposures are added to or removed from the pool of exposures) if it is clear that the newly added exposures will also fulfil these criteria.

In addition, it should be made clear that the criterion - that any receivables being transferred to the securitisation should be current, i.e. they should not include delinquent obligations - refers to the point in time when the receivables are transferred. This means that the receivables must be performing at the transfer date to be classified as qualifying securitisation, but could be non-performing during the life of the securitisation.

Lastly, regulators and policy-makers should give due consideration to the risks that run as a consequence of designation of qualifying securitisations:

- Such designation may provide an implicit subsidy to assets or institutions that qualify easily. Regulators should consider the policy implications of an increased flow of capital to those markets or institutions; and

- It is important to consider what impact establishment of qualifying securitisations will have on perception of non-qualifying securitisations. We agree with the ECB and BoE that its necessary to support more junior tranches of safe and robust securitisation markets. In this regard, continuing to help improve the availability of data and analytics and seek to ensure that these are delivered as efficiently as possible, is key.

At the same time, however, we believe that addressing the concerns outlined in the section on impediments to revival of securitisation markets regarding achieving appropriately (and non-punitive) risk weights for all securitisation positions, establishment of a level playing field for risk retention, and establish appropriate disclosure requirements for private transactions are even more critical to the reestablishment of a healthy securitisation market in the EU.

Annex III - Detailed comments on principles of a qualifying securitisation

We would disagree with the approach that would view synthetic securitisations as not being qualifying securitisations. This approach would remove a large number of securitisations which, from a regulatory policy perspective, would otherwise be eligible.

One example is securitisations of bank loan receivables, where applicable bank secrecy, data protection and privacy laws would prevent the bank from transferring the loans to an SPV. Contractual arrangements that would explicitly authorise the bank to assign and transfer loan receivables to a third party (e.g., so-called "asset trading clauses") may be common in some markets like large caps or auto financing; they are not used in consumer loans and loans to small and medium-size entities (SME). Consumer and SMEs view lending as a sensitive relationship and would normally not accept to face a third party as servicer. Deutsche Bank, like other banks in this market, uses synthetic securitisation to hedge the credit risks stemming from its loan book. Deutsche Bank established well-known securitization programmes that systematically hedge risks whenever new loans are granted. We consider these programmes as tools for supporting lending to both consumers and corporates.

Another example is securitisations that use two-tiered structures involving two SPVs, where the first SPV holds the assets, the second SPV issues the notes that fund the acquisition of the assets and where the funding is passed-on to the first SPV through a credit linked note. Most U.S. securitisations (including asset-backed commercial paper programs) are based on that two-tiered structure. The reason for using two-tiered structures is to enhance bankruptcy remoteness of the SPVs and to enhance investor's rights. The two-tiered structures are usually viewed as true-sale transactions because they use an initial transfer of receivables to the asset holding SPV, which segregates these assets from the originator. The second transfer to the issuing SPV, which is achieved synthetically, should not disqualify these transactions.

We believe that simple synthetic securitisation structures as described in the first example bear a significant advantage with respect to the moral hazard problem involved in the separation of underwriting and risk bearing, which is typical for all forms of risk transfer, if the originating bank can ensure that underwriting staff and credit officers monitoring the exposure do not decide that the risk in fact should be sold via a securitisation transaction. Fulfilling this requirement should qualify a synthetic structure as qualifying.

Paragraph 128 – The first sentence should read: "*The underlying assets must be receivables, e.g., loan, lease or rental receivables, where the terms of the receivables are clearly defined*." The examples given should be exemplary and not exhaustive. It is our understanding that the underlying assets may also include the objects to which the loan, lease or rental agreements relate to, e.g., automobiles, aircrafts, marine container, equipments or software licenses (see paragraph 133).

Paragraph 129 - The requirement to include a period of market stress could eliminate any assets or programs of underwriting started after 2008 or the reference market period. Regulators may want to substitute projected performance in a stress scenario.

Paragraph 130 – It should be clarified that it is the investor (e.g., the note holder), or the agent or trustee acting on behalf of the investor, that must have recourse. The term "recourse" should be defined and should not be construed as legal ownership of the receivables and being able to claim on the obligors. Key element of the definition should be the legal segregation of both the receivables and the related collections and the use of cash flows in accordance with the agreed priority of payments (the "waterfall").. Referring to the "General Remarks" above, we would propose to delete the second part of the sentence (starting with "i.e., it may not rely…").

Paragraph 131 – It should be clarified that the requirement of "consistent origination in the ordinary course of business" does not exempt multiple-originator securitisations. It must be possible to securitise assets that have been created by different initial lender, provided it has been demonstrated that the credit policies or underwriting criteria applied by those lenders are substantially the same and hence result in a sufficiently homogenous portfolio.

Paragraph 132 – It must be possible to securitise undrawn credit facilities or to include them into the portfolio.

Paragraph 133 – The requirement described in paragraph 133 should be waived. It is not reasonable to view securitisations that use second ranking security as ineligible. The alternative would be to release the assets and treat the receivables as unsecured. The better approach would be to disclose the risk attached to second liens to the investor and ask him or her to not rely on such security. Further, we would propose to delete the word "tangible" to include assets like software licenses.

Paragraph 135 – It should be clarified that the "transfer of underlying receivables" may include other forms of effective segregation. The German Act on the Creation of a Refinance Register (introducing a new Section 22j to the German Banking Act) enables the originator of receivables to sell them to a special purpose vehicle (SPV) without physically transferring them. The SPV's claim to the transfer of the assets is entered into the refinance register maintained with a credit institution and thereby segregated from the originator's bankrupt estate. Upon bankruptcy of the originator the SPV could request segregation of the receivables in accordance with Section 47 of the Insolvency Act. Referring to our "General Remarks" above, we would propose to (i) replace the words "true sale in its" used in the second line with "a" and (ii) delete the third bullet.

We also refer to Article 242 point (11) of the CRR, which defines "synthetic securitisation" as a securitisation where the transfer of risk is achieved by the use of credit derivatives or guarantees. We construe the third bullet as recognizing synthetic securitisations as "qualifying", provided the risk transfer is achieved by financial guarantee. Financial guarantees are characterised by the fact that the beneficiary can draw there under only if it demonstrates and evidences that it suffered a real loss. Usual features of synthetic securitisations based on financial guarantees are the requirement to (i) hold the protected receivable on its own books, (ii) determine actual losses by performing a complete work-out (which may take multiple years) or, if so agreed, by consummating a sale of the receivable in the market on arms lengths and (iii) have the actual losses certified by a an accounting company acting as loss auditor.

Paragraph 137 – We construe paragraph 137 as requiring a consistent approach in applying the same delinquency and default definition to all assets of the same securitisation, but not as to apply the same definitions to other securitisations, at least not to those transaction that securitise different assets originated in different regions.

Paragraph 139 - It should be clarified that it is the servicer (acting on behalf of the investor), that must be able to exercise the voting and enforcement rights related to the securitized assets.

Paragraphs 140 and 141 – Referring to our statement on *Onerous disclosure requirements* above it should be clarified that disclosure to the individual investor in accordance with Article 409 CRR would automatically fulfil the requirements defined in paragraphs 140 and 141.

Dear Sir or Madam,

It was with great interest that I read your joint discussion paper „The case for a better functioning securitisation market in the European Union". With this email I would like to follow your invitation to provide feedback.

Although I work as a fixed income portfolio manager, I would like to offer some academic comments. Last year I completed my PhD in economics at the University of Cambridge. The title of my PhD is „The role of the financial sector in macroeconomic modelling". In three papers I analyse the importance of the financial sector also with respect to the impact on the propagation of monetary policy.

During my PhD I spent some time in the Financial Stability Division of the ECB where I began work on a theoretical model with the aim to include a securitisation market into a monetary DSGE model. Reading your discussion paper reminded me that my paper might be able to provide some theoretical foundations to the current discussion. I am attaching my complete thesis; I am referring to Chapter 4.

The model builds upon an ECB working paper (one of its authors was my supervisor during my time at the ECB). The idea is to augment an existing monetary DSGE model by a securitisation market. The baseline model features a complex banking sector in which banks optimise their balance sheet under the constraint of a regulatory capital requirement. We supplement this by allowing banks to open a "securitisation desk" and to sell their securitised loan portfolio, or to borrow against it in the repo market. Impulse response analysis shows that securitisation and repo financing make the financial system more resilient to financial shocks if the repo market remains intact. This is in line with findings in the empirical literature on securitisation. If the repo market shuts down as endogenously determined haircuts increase, however, shocks to the health of the financial sector get amplified and have severe real economic consequences. We then apply the augmented model to a series of macroprudential policy exercises.

Maybe you will find my research of interest for your purposes. I would be honoured if this could be the beginning of a discussion and am looking forward to hearing from you.

Yours sincerely,

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Shaped by the past, creating the future

Durham University

Durham Law School

Dear Colleagues,

Re: A response to the "Discussion Paper on 'The case for a better functioning securitisation market in the European Union"

The Discussion Paper is a timely and well thought of initiative. Securitisation as a financing method has had bad press since the financial crisis. However, it is important to set certain standards and principles for a better and well functioning securitisation market. It is obvious that securitisation has clear impact on small businesses as well as the real economy as a whole. Therefore, with clear principles it needs to be fed back into the market.

I fully agree with the benefits of a well functioning securitisation market as outline in section 2. There is a need to be reminded of these benefits to establish a well functioning market and to gain the confidence of investors in the markets.

In terms of questions related to pages 15-16 *impediments to investors*: I agree that these are impediments for investors. Risk retention requirements in the aftermath of the crisis (s. 122(a) of the Credit Requirements Directive) will probably alleviate the concerns on this point. But particularly, the lack of transparency in securitisation transactions and the complexity of these transactions are also impediments. I think further transparency would assist investors in their decision making process.

In terms of questions related to pages 19 *et seq.*: I agree that risk should be concentrated on the investors with less leverage. That would protect them in the event of another crisis as they would have sufficient capital to act as buffer. Banks also should take less part in the securitisation market.

I agree with establishing a concept of 'qualifying securitisation'. It is also very important to define clearly what a *qualifying securitisation* is. While the definition stated on page 19 is a good definition that captures the essence of what a qualifying securitisation should be and I agree with it, it needs to be refined in the regulations. Who should *understand*? What is *predictability* and *consistency* in this definition? On page 19, it is stated that 'such securitisations should be simpler…' but what is a *simple securitisation* and what are the characteristics of a simple securitisation? By nature securitisation is already complex to many lawyers and non-lawyers (for many it is already difficult to comprehend the assignment of future receivables).

Box 3 on pages 23-24 is an excellent method to start establishing these principles that will govern a well functioning securitisation (Qualifying Securitisation). I agree with the broad principles set in Box 3. It is important that the underlying assets and debtors are limited with those principles. These principles are in fact, I think, measures to specifically rectify the damage caused by the originate-to-distribute type of securitisation based on mortgages. In my opinion these principles are sensible and have the ability to prevent a market collapse. Also, these points ring fence as to what should be included and how should a securitisation transaction be. These have the ability to establish a standard version for securitisation transactions.

On page 21, I would agree that investors' access to credit data would provide investors with a better investment decision making opportunity. That would also support the emergence of securitisation markets because investors would be able to make a more informed decision. Credit registers would help and that would reduce the effects of information asymmetry. This would be mainly effective against SME originators. For other types of businesses (companies) there is a possibility to check other credit history via, for example, the Experian or the Companies House where security interests (charges) are registered. Obviously it would be better if there is a security interest register that is easily accessible on the internet as it is in other countries like Canada and USA where the current financial status of a company and its assets can be ascertained.

In terms of developing a framework where various authorities and market participants set their own eligibility criteria, I would think that it would be better if there should be overarching principles where these authorities and participants establish the criteria following those. Otherwise, it might be a similar type of regulation to pre-crisis 'light touch regulation' which would lead to further associated problems. The role of appropriate authorities might be to monitor that the transaction fulfils the requirements set in Box 3 of the Discussion paper. For example, loans to subprime borrowers should not be part of this framework.

As conclusion, this is a very welcome initiative and I am sure that the principles from this study would establish a well functioning securitisation market.

Yours sincerely,

Dr N. Orkun Akseli
Durham University Law School

Bank of England and European Central Bank: The case for a better functioning securitisation market in the European Union. A discussion Paper. May 2014

Background

The Dutch Securitisation Association (DSA) was established in 2012 as representative body of the Dutch securitisation industry. Our membership includes issuers of securitisations both from the insurance and the banking industry, and we are operating in close cooperation with the Dutch investor community.

Our purpose is to create a healthy and well-functioning Dutch securitisation market. We try to achieve this i.a. by providing a standard for documentation and reporting of Dutch RMBS transactions, promoting (in close cooperation with PCS) further standardisation and improvements in transparency, and active involvement in consultations about future regulation of the securitisation market.

Against this background, we would like to comment, on behalf of all Dutch RMBS issuers joined in the DSA, on the Discussion Paper.

Our comments are provided in the order of the questions raised in the Paper:

· Do respondents agree with the benefits of a well- functioning securitisation market as outlined in Section 2?

In general, we do agree with the benefits mentioned. In addition we would like to stress the following points:

39. Investor base: Dutch banks are historically faced with a “funding gap”: due to the very high percentage of contractual savings through Pension Funds, savings deposits on bank balance sheets are relatively low and insufficient to fund all loans to the “real economy”; securitisation provides a way to bridge this gap with wholesale funding attracted from (foreign) investors with an appetite for specific Dutch asset classes (in particular Dutch residential mortgages).

Also, on a more micro level, new (foreign) entrants in the Dutch mortgage market will typically have insufficient retail funding sources, and therefore securitisation can help promoting competition by providing entrants the funding they need to build up their product offering.

44. Transferring risk and 47. Risk weights: Although we are fully supportive of risk retention rules as a way to maintain “skin-in-the-game” and prevent a return to the negative aspects of the “originate-to-distribute” model, we have to stress that for Dutch RMBS, with cumulative loss rates of below 0.5%, a 5% retention requirement is at odds with anything close to significant risk transfer.

Anyway, a 5% retention requirement irrespective of the loss rates on the underlying portfolio, is not helping securitisations of assets with low loss rates, like Dutch RMBS.

So Dutch RMBS under current regulation is and will be mostly a funding tool. Consequently, most originators will only sell the “liquidity products”, and keep the mezzanine tranches or “credit products” since the spreads on these products will not be commensurate with the still very low embedded risk.
49. Liquidity asset. We have to point to the self-fulfilling-prophecy issue around the LCR. The uncertainty about the regulatory treatment of RMBS in the LCR led to a waiting game on the part of investors, which surely did not help to increase the market liquidity of the product. The currently proposed inclusion of RMBS in level 2B is not a proper reflection of the liquidity characteristics of the product should the period of uncertainty have been shorter.

- Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?

Again we fully agree with your analysis, but with two additional remarks:
73. Liquidity requirements. We would like to emphasize the impact of the regulatory treatment of the trading book on secondary markets. This creates a vicious cycle. Less market liquidity leading to more adverse regulatory treatment leading to smaller trading books, leading to less liquidity etc.
76. Chart 7. While the difference between EMEA and Global is striking, the result would be even more extreme for Dutch RMBS (and other high quality European ABS such as UK RMBS, German Auto ABS) instead of the collective securitisations of EMEA.

- Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?

In addition to your analysis, we would like to mention:
83. Retention: we also refer to our comment on 44. above.
84. Regulatory uncertainty: we also refer to our comment on 47. above. For issuers of Dutch RMBS there is no tangible capital relief left, even under current and proposed regulations.
Most of our concerns are now about the regulatory uncertainty of investors.
88. Systems. While the systems infrastructure in the Netherlands is of high quality, and through independent third parties also available to smaller originators, we note that the uncertainty about permanently changing additional systems requirements is a serious impediment. A point in case is the CRA3 implementation, where a legislation intended to regulate the Credit Rating Agencies ends in a huge systems challenge for issuers, even those who issue unrated paper.
92. Alternative Funding Conditions. With the TLTRO, the “progressive withdrawal” has come to an end. By the time the withdrawal resumes, the securitisation infrastructure may have disappeared and official sector schemes may have to take a more permanent position.

· Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

We do agree, but we have our doubts about the perceived low liquidity of the securitisation markets. Investors are currently in a holding pattern. There is lack of supply, and exchanging short maturities for longer ones does not make sense against the background of regulatory uncertainty. However, those investors who want to sell have no problem to do so. Not surprisingly, Spanish RMBS was one of the most liquid markets in recent years.

· The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

If the definition conforms to the statement in 126. "to identify securitisations where their simplicity, structural robustness and transparency enable investors to model risk with confidence", we do agree.

We would however like to comment on the following points:

126. "The designation would apply to all tranches of the transaction". In our view it becomes increasingly difficult for investors (and issuers alike) to model risk with confidence when you enter mezzanine or subordinated territory, especially if these tranches are in short supply in primary issuance markets.

134. Although we agree that certain commercial real estate mortgages qualify, we wonder what criteria you have in mind to choose between qualifying and non-qualifying transactions. Criteria like granularity, both in terms of loans and maturity of the loans, may play a role here.

· Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?

Leaving aside the question about the current level of liquidity in the markets, using the concept of 'qualifying securitisations' to reduce the regulatory capital requirements for the trading book would certainly help to increase liquidity.

· These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?

We envisage a structure such as the one developed for loan level data with the European Data Warehouse, where a private/non-profit organization, funded by the industry, would be able to quickly turn around requests for confirmation of the 'qualifying' status.

PCS, maybe in a somewhat amended set-up, could also fulfil this role.

In this respect we subscribe to the analysis as provided by PCS on this subject in their comments on your paper.

· Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?
All qualifying asset classes should provide loan level data.
The European Data Warehouse, supported by their shareholders, including the Dutch Securitisation Association, are actively promoting better data quality and accessibility.

· Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?
From our practical experience over the last one and a half year we have learned that standardisation of prospectus lay-out and definitions as well as investor reports has been extremely helpful in promoting a relatively healthy Dutch RMBS market.
We encourage other jurisdictions to follow the example of the Dutch Securitisation Association and in a next stage would like to work together with other jurisdictions in further standardisation efforts.

· Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?
With a proper emphasis on standardisation and transparency, we do not see the addition of credit data registers as an urgent requirement. In the longer run, credit data registers could help the development of the SME securitisation market, but setting up these registers will be a complex and costly excercise.

· In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?
For most active securitisation markets, rating agencies and (investment) banks publish comprehensive accumulated data derived from the investor reports of the outstanding transactions. Further standardisation of these investor report may help in improving these aggregated data. Aggregate data for all assets of a certain asset class (whether or not securitised) show, at least in the Dutch experience, minimal deviations from the data on the securitised assets. However for newly (re-)emerging asset classes (like SME securitisation) aggregate market data may be useful as long as insufficient data on securitised pools are available.

We see primarily a role for national regulators to collect and publish these statistics as an independent source of information.
On a related point, standardized definitions in Europe, like a uniform definition of Default, would be beneficial.

- Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

The fragmented nature of the European market, with different characteristics of transactions coming from different jurisdictions, dilutes the benchmark concept. Only when the market returns to the volumes seen in the past, benchmark indices for certain asset classes might gain value. The existing benchmark for Dutch RMBS currently does not add much value.

- Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

Providing this kind of information would, in addition to their own analysis, be very helpful for investors, so should be encouraged.

- How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

Although we do not experience a direct problem in this respect for Dutch issuers, we agree that counterparty and concentration issues facing the providers of these facilities, may hamper the future growth of securitisation markets. So solutions like central bank provided/guaranteed facilities and facilities in a custodian like environment, are welcome. Also a further reduction of rating dependency for these kinds of facilities would be beneficial.

- With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?

Although implicitly mentioned in your document, we would like to emphasize that apart from differentiating regulatory treatment between "qualifying" and "other", an overall adjustment of capital and liquidity requirements for securitisations, bringing the requirements more in line with those for Covered Bonds, whole loan purchases etc., would be essential for a revival of the securitisation industry.

· Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

Further harmonisation of the legal and tax structure between European jurisdictions would help to develop a more pan-European securitisation market.

· Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?

Other products (like Covered Bonds) share some of the benefits of securitisation, but also have their own disadvantages. Securitisation is part of the funding mix of financial institutions, but should generally not be the only source of funding.

· Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?

The two main risks of a "qualifying"/"other" approach are 1) watering down of the qualifying criteria, making them hardly discriminating and 2) cliff-effects. So we would generally favour a strict definition of "qualifying" combined with realistic requirements for "other" transactions, which would not unduly threaten the existence of these "other" securitisation products.

Ref.:EBF_008877C

Brussels, 4 July 2014

Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of some 4,500 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU alone.

The EBF welcomes the opportunity to express the views of the EU banking industry on the discussion paper published by the European Central Bank and the Bank of England on the case for a better functioning securitisation market in the EU.

The EBF response starts off with a summary of key points and continues with specific answers following the order of the questions put forward in section 5 of the discussion paper[1]. We have included several sub-sections in our longer responses for the sake of legibility.

Key points

- The impact of new policies need to be assessed against the background of the current regulatory landscape. A number of policy measures of different nature have been (or are to be) enforced with a direct effect on diverse securitisation instruments. Policy makers should have clear and accurate information about the impact of the regulations after the crisis. Only in the light of that information the effects of new initiatives could be rightly construed.

- European policy makers should take the lead and ensure a workable design of the revised prudential framework for securitisations currently under review at the Basel Committee.

- The short-term liquidity coverage ratio (LCR) will significantly affect the internal allocation of available funding to different categories of assets. Further recognition should be given to securitisations as liquid assets lest the LCR becomes a binding constraint leaving other measures ineffective.

- The tradability of securitised instruments is important for the sustainability of a liquid market. For that purpose, the prudential rules of the wider scope of financial institutions should be revised including those of asset managers and insurers.

- The case for SME exposures needs special attention. The dynamics of the market, the actual rating criteria of agencies, their null contribution to meet new liquidity requirements and the limited access to other type of funding renders the SME asset weaker than others in the face of an overwhelming regulatory and economic environment.

[1] "The case for a better functioning securitisation market in the European Union". The Bank of England and the European Central Bank (May 2014).

- The EBF agrees at large with the definition proposed for qualifying securitisation as long as it embraces a wide range of tranches. Safety should take priority over seniority.

- The cap imposed by the sovereign rating impedes the natural development of securitisations in member states that no longer show the highest external rating note. The characteristics of the underlying assets should be analysed and their sheer ratings published separately from that of the sovereign where part or the whole of the assets are domiciled.

- The EBF is of the view that a certification mechanism should be considered to ensure a unique and transparent interpretation of the principles included in the definition of qualifying securitisation.

- In the opinion of the EBF a credible independent certification should be provided by a private sector entity backed with the participation of the public sector for surveillance purposes and to confer official character notably in the case of differences of interpretation of the underlying regulatory framework.

EBF contact person: Gonzalo GASOS – Senior Policy Adviser (g.gasos@ebf-fbe.eu).

EBF comments on the questions of the discussion paper

Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?

We agree with the declared political aims on the need to support the recovery of the securitisation channel on a robust foundation, particularly in Europe, as it could help filling the funding gap notably for residential mortgages and small and medium sized enterprises (SME), promoting a balance between bank and non-bank financing.

Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?

We would like to underscore certain impediments from an investor's viewpoint:

– The (insufficient) recognition of securitisations as liquid assets;

– The overly conservative prudential treatment of securitisation assets (as compared with other similar risks) under Solvency II;

– An inconsistency in the risk assessment of small-medium enterprise (SME) exposures by the credit rating agencies.

Further recognition of securitisations as liquid assets

Firstly, securitisations should be given more value as assets eligible for banks short-term liquidity management buffer (LCR). The inclusion of a wider range of securitisations in the LCR buffer would provide market liquidity – as there will be a greater pool of buyers and sellers. This would also increase the perceived tradability of securitisations by other financial institutions like insurance companies and pension funds as they could easily trade out if they decide to re-balance their portfolios.

The prudential treatment of securitisation assets under Solvency II

In the same vein, the capital charges proposed by Solvency II may discourage insurers from investing in securitisations relative to other assets. Qualifying securitisations with simple structures and well identified and transparent asset pools with predictable performance should be treated less conservatively than is currently proposed.

An inconsistency in the risk assessment of small-medium enterprise (SME) exposures

Another impediment is the fact that the relative risk measure from rating agencies is sometimes not compatible with the risk measure of policy makers and regulators:

- The assessment of rating agencies puts SME exposures in a relatively poor status that is inconsistent with the regulatory capital requirements framework for the underlying assets: rating agencies are penalising SME ABS by assuming too high default rates for the underlying counterparts for their base case (before stress). Under the regulatory framework the riskiness of an SME exposure is lower than that for a BBB/BB rated large corporate exposure: Accordingly, in the standardised approach the former is required a 75% risk weight whilst the latter is assigned a risk weight of 100%. Also, in the internal rating based approach, SME exposures have lower risk weights due to the lower correlation factor in the Basel formula which rightly reflects the benefit of wider diversification. In theory, if external ratings and regulatory risk measures were compatible, a securitised portfolio of SME should thus require less capital than a securitised portfolio of BBB/BB large corporate exposures. However, a securitised portfolio of SME exposures does not require less capital, and oftentimes requires more capital than a securitised portfolio of BBB/BB large corporate exposures. This anti-SME bias in the risk assessment done by rating agencies undermines the economic sense of SME securitised assets.

- In Standard & Poor's[2], the SME CLO "*criteria uses the concept of an archetypical European SME pool for which [S&P] have assigned an average credit quality assessment of 'b+' as the starting point for obligor default analysis when assigning 'AAA' ratings. The archetypical pool represents [S&P] view of the average characteristics typically featured by SME portfolios securitised in Europe*.

- In fact, actual default data on SME pools in Europe does not support this arbitrary assumption of B+ since default rates tend be much lower than implied by a B+ rating. Moreover this overall B+ assumption does not reflect the reality of historical defaults even during the crisis. Interestingly, B+, which is more appropriate for highly leveraged corporate loans, has a regulatory risk weight of 150%, twice the level that is required for SME, at a 75% risk weight.

In short, with a B+ assumption by S&P (Moody's also considers European SME as a 'B1' quality), the securitisation tranches of 75% risk-weighted SME pools will be much more capital intensive due to a larger size of the subordinate tranches than the tranches of a 100% risk-weighted BBB/BB corporate portfolio. There represents an inversion in the measure of risk.

Finally, as regards additional impediments to investors, we believe that other counterparty risks are to be considered. For example:

- Restructuring of banking groups in some of those countries which suffered most the financial crisis;
- Servicing discontinuity;
- The risk of a concentration of only a small number of highly rated swap counterparties in Europe.

Furthermore regarding economic concerns of investors, it is mostly the economic environment that causes risk aversion on the capital structure or requires relatively high costs

[2] Standard & Poor's: "European SME CLO Methodology and Assumptions" (January 2013).

for a successful public placement. Presently the low interest rate scenario contributes to a lower deterioration of the assets originated in countries which suffered most the financial crisis. It remains to be seen what will happen if the interest environment changes. The market is anything but static.

Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?

Three problems stand out as potential impediments to issuers.

An actual concern is that the capital treatment of securitisations depends on the degree to which an originating bank is deemed by it supervisor to have transferred a significant amount of the risk of the underlying assets from its balance sheet to that of the special purpose vehicle (SPV). Different supervisors in Europe have different approaches to significant risk transfer which may limit the capital relief a bank can achieve in undertaking a securitisation and therefore its ability to redeploy the freed-up capital in additional new lending to the real economy.

Secondly, the Basel Committee is proposing changes to the securitisation rules which may make securitisation significantly more expensive for banks. Whilst the proposals have been moderated in the second consultative paper of December 2013, the absence of certainty and continued perception that the BCBS will calibrate the whole market to a level relevant to US sub-prime casts a shadow over the market.

In the same vein, the current differences between EU and US reporting and disclosure requirements are examples of regulatory uncertainty which we see as a major impediment to a well-functioning securitisation market, as is the differential application of retention requirements – on issuers in the US and on investors in Europe. This regulatory uncertainty undoubtedly increases the cost and complexity of bringing a securitisation to market, reducing its attractiveness as a funding vehicle.

Finally, the regulatory environment of securitisations has tightened significantly after the crisis with no rigorous overall impact assessment having been conducted since. There are grounds for thinking that the combination of regulatory constraints can squeeze the origination side of the securitisation market. It is imperative to have an overall view of the regulatory changes introduced after the crisis before assessing new actions. As a matter of background, several new regulations enacted in the EU (see synopsis of current EU regulations in box 1) have tightened up the prudential treatment of securitisations by means of:

- Alignment of incentives between originators and investors or *skin in the game*;
- Partial reduction of mechanistic reliance on external ratings;
- Measures to increase transparency;

- Adequate control of credit rating agencies;
- Increased capital requirements;
- Review of correlation trading books;
- Heightened requirements for complex structures.

Box 1: Regulations already enforced in the EU related to securitisations

(i) Initiatives to promote a better alignment of incentives: Retention requirement.

- Securitisation sponsors or originators are required to retain a part of the risk of the underlying assets to correct possible misalignments between the interests of securitising institutions and those of investors and to encourage originators to apply rigorous lending policies.
- Introduced in the EU banking legislation, which entered into force on 31 December 2010 (CRD II[3] Article 122a) and also in other regulations affecting other potential investors in bank-originated securitised products such as investment funds and insurance companies.

(ii) Measures to increase transparency

- CRD III[4] has amended EU banking legislation to include a wide range of new disclosure requirements which the Basel Committee had recommended, particularly concerning asset-backed securities held in the trading book, the sponsorship terms for off-balance-sheet items and the methodology used for valuating products on the balance sheet.
- The European Central Bank, in order to ensure an adequate risk assessment of the asset-backed securities that the Eurosystem accepts as collateral, published in December 2009 its decision to require loan-by-loan information on the underlying assets backing securitisations, as a factor to be taken into account in the eligibility criteria.

(iii) New regulations on credit rating agencies

- Credit Rating Agencies have now been made subject to specific regulatory supervision in the EU[5], including registration, measures to reduce conflict-of-interest, requirement to use models that are rigorous, systematic, consistent and subject to validation based on historical experience.

(iv) Increased Capital Requirements in Basel 2.5

CRD III transposed into European legislation amendments made by the Basel Committee to the Basel 2 framework known as Basel 2.5. These amendments have been enforced in the EU by 31st December 2011:

- The adjustments to the Basel II framework announced by the Basel Committee in July 2009, which received several adjustments in June 2010, established that securitisation positions held in the trading book need to be subjected to similar charges as those applied to securitisation positions held in the banking book.
- Additionally, *correlation trading books* were exempted from the full treatment for securitisation positions, qualifying either for a revised standardised charge or a capital charge based on a comprehensive risk measure.
- Also, with the aim of discouraging the issuance of the most complex ABS structures, requirements for re-securitisation have been strengthened by including a new weighting scale created *ad hoc* for these

[3] EU Capital Requirements Directive II.

[4] EU Capital Requirements Directive III.

[5] EU Credit Rating Agencies Regulation voted in European Parliament on 16 January 2013.

products, specifying increases at times of over 100%. In addition, all the lines of liquidity support for asset-backed securities, irrespective of their maturity, have a credit conversion factor of 50% (formerly, the conversion factor for lines with a maturity of less than one year was only 20%).

Significant measures have already been taken to address the shortcomings identified in the crisis and including the specific impact on securitisation and re-securitisation of the European Credit Rating Agencies (CRA / CRA 2 & CRA 3).

Other policy measures that will affect the regulatory picture of securitised instruments are also in the making (see synopsis of policy measures underway in box 2), including:

– The Basel 3 leverage ratio;

– The Basel 3 liquidity coverage ratio;

– The Basel 3 net stable funding ratio;

– The fundamental review of the trading book;

– The Basel Committee revised securitisation framework.

Box 2: Upcoming policy measures affecting securitisation

(i) The Basel 3 leverage ratio

- Retained positions of securitisation exposures as well as other forms of credit enhancements provided to the vehicle by the originator (e.g. liquidity facilities) could be included in the calculation of the leverage ratio.

- For non-derecognised securitisations, the underlying securitised portfolios (as opposed to the securitisation exposures) could be included in the leverage ratio calculation. Credit risk mitigation, synthetic (or unfunded) securitisations, will not reduce the exposures of the underlying portfolios.

(ii) The Basel 3 liquidity coverage ratio

- The original proposal was that securitisation bonds, even those with the highest qualifications or with sovereign guarantee, would be considered as completely illiquid assets for the calculation of the liquidity coverage ratio. This implies that banks should retain a stock of high quality liquid assets equivalent to 100% of the amount of debt securities maturing within the 30-day time horizon of the standard and 100% of the amount of assets that could potentially return to banks' balance sheets due to embedded options in these financing arrangements.

- The revision of the Basel liquidity framework of January 2013 contemplates some degree of recognition as highly liquid assets of certain RMBS. Nevertheless, the range of bonds that comply with the stringent conditions will be very limited.

(iii) The Basel 3 net stable funding ratio

- This standard provides a measure of liquidity risk exposure that acknowledges the need to fund securities in trading inventories or securitisation pipelines in the face of illiquid markets. As specified in the original proposal, banks are required to hold 65% stable funding for all residential mortgage loans that are warehoused in order to be securitised. Moreover, banks have to hold 100% stable funding for all other structured products on their balance sheet, like securitisations, including the substantial amounts of MBS that European banks are holding in the context of central bank operations.

(iv) The Basel Fundamental Review of the Trading Book (FRTB)

- According to the FRTB a bank mitigating long risk securitisation positions with short risk securitisation positions will be requested to hold more capital than if it had only held the long risk position with no risk mitigation. It would ultimately pose a disincentive to banks to have well hedged books.

(v) The Basel Revisions to the securitisation framework

- The Basel Committee is looking to change the risk weighting of securitisation positions. It consulted with the industry twice on proposed changes. The EBF position regarding these changes will be discussed later in the paper.

Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

Yes, we agree. However, it must be pointed out that nowadays market illiquidity is mainly explained by the absence of supply rather than by the limited investor demand. High demand versus limited offers has led to a significant spread compression and low trading volumes. Market illiquidity is only one of the variables affecting pricing. In fact there are idiosyncratic and systemic credit risks to be taken into account, as seen since 2007.

As for the coupon features, there is an increasing number of fixed rate tranches in the market. Floating rate notes are expected to rise in the longer term with higher inflation and increasing interest rates. We agree that buy-and-hold investors are currently the dominant investor segment and this has resulted in limited trading activity.

We also refer in other sections to some factors that can hamper market liquidity.

The view of the Bank of England and the ECB is that a ‘qualifying securitisation’ should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a ‘qualifying securitisation’ not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

General EBF comments on the definition of qualifying securitisation

We are of the opinion that Europe should take the lead in the definition of ‘qualifying securitisation’ and in the review of related regulations to try to set up in as short a term as possible the right environment for a revival of a well-functioning securitisation market and to play an influential role in the design of policies at global level including in the domain of the Basel Committee and IOSCO.

The scope of qualifying securitisation should be linked to 'safe securitisation' which is not an exclusive characteristic of the most senior tranches. A 'safe securitisation' would qualify because it is simple, its terms are understandable by investors and the risk involved can be assessed without difficulty. We consider that the focus of the political action should not be constrained to the most senior tranches of securitisations that are simple and transparent, but apply to the entire ABS transaction.

Consequently, we agree with the ECB and BoE approach to recognise as qualifying securitisation those transactions that are simple, structurally robust and transparent, as they allow proper risk assessment by investors and other interested parties and are less prone to raise systemic risks, contrarily to complex and shoddy securitisations.

A considerable part of the instruments that played a relevant role as triggers of the last financial crisis (e.g. US sub-prime securitisations) were present on the balance sheets of institutions, banks in particular, around the world. However, had the origination of those instruments been put under stricter control they would have not spread as they did. Therefore, we think that origination is the critical stage of the securitisation process for prudential purposes. A sound definition of qualifying securitisation could be very useful in this context.

We would also suggest a stronger view on the concept of "standardisation". To obtain real liquid market it would be necessary, in addition to a greater standardisation in terms of eligibility criteria of the underlying collateral, the use of standard (i.e. same) structural features (priority of payment, terms and conditions of the notes, trigger events, definitions, etc.) and harmonisation of reports (same format and frequency).

Qualifying securitisations and policy objectives

First and foremost, we share the view expressed in the discussion paper that the "*use of qualifying securitisation should not be regarded as a one-size-fits-all approach; additional requirements may be needed depending on the application*"[6]. In our view, the contemplated approaches and definitions for qualifying securitisation should be aligned with the two quoted potential benefits: *improved secondary market liquidity* and *specific capital treatment*[7]. Also, we agree that *different objectives may require different market characteristics*[8]. Consequently, the approach for defining qualifying securitisation is subject to prior identification of clear policy objectives.

Those policy objectives may encompass the following:

1. *Reviving the EU securitization market by supporting simple, structural robust and transparent products;*
2. *Focusing on the economic sectors approved by policy makers;*
3. *Reducing reliance on rating agencies within the regulatory capital framework;*
4. *Increasing transparency for investors;*
5. *Increasing the secondary market liquidity.*

[6] Point 20

7 Point 20

8 Point 50

The EBF supports all these policy objectives. We consider that the EU regulatory approach (under CRR, both capital and liquidity frameworks, and Solvency II) and the future international regulatory framework for securitisation should be made more risk-sensitive and aim at correctly reflecting the characteristics of each securitisation product (credit and liquidity risks). Thus, the potential uses for *qualifying securitisation* or *high quality securitisation within the qualifying securitisation category* need to be clearly assessed and stated. In our opinion, the high quality securitisation can be used for:

a. *Capital requirements: Basel risk weight floor*

A minimally disruptive change in the Basel capital framework would be to allow a lower floor for regulatory capital, on a fixed-value basis or a risk sensitive basis (which would mainly depend on the risk sensitiveness of the underlying assets). For funding purposes, the key issue is the senior tranche which currently attracts too much capital for high quality pool assets. The same issue concerns the EU ABCP transactions (alternative and important source of funding for EU corporates, not correlated with their credit risk) which would be highly penalised by the proposed risk floor (i.e. 15% RW).

b. *Capital requirements: Lower risk weights*

Lower risk weights would be justified by analysis of the risk involved. The EBF supports the alternative proposal for calibrating the RWAs, the Conservative Monotone Approach (CMA).

c. *Liquidity requirements: LCR Haircuts*

Minimally disruptive change into the regulations would be to permit lower haircuts for qualifying securitisations.

d. *Liquidity requirements: LCR eligibility*

As contemplated by the European Commission, a broader set of asset classes could be granted LCR eligibility. Short dated real economy securitisations like auto loans justify this approach.

Qualifying securitisations and definition approach

We welcome the high level principle-based approach proposed by the ECB and BoE. We understand that such a "*designation is not intended to provide an opinion on credit or other risks, but make the assessment of these risks more straightforward. The designation would apply to all tranches of the securitisation*."[9] In addition, we welcome that this principle-based approach should serve as a building block or "*platform*" from "*which more detailed criteria could be built as appropriate (e.g. regulatory capital and liquidity treatment, credit rating assessment, etc.*)"[10]. Therefore, the "*designation*" level and the "*regulatory treatment*" level (either capital or liquidity) do not rely on the same amount of information or requirements. For the regulatory treatment level, specific and additional criteria need to be formalised, and we consider that the regulatory treatment should be appropriately differentiated across the

[9] Point 126

[10] Point 127

tranches of qualifying securitisation. This appropriated regulatory regime would better reflect the level of risks associated with these positions.

Indeed, regulators could propose:

1. A more differentiated risk-based approach (a gradual scale would assess on the regulatory side the level of risk and the regulatory requirements), or
2. A binary approach where "*qualifying*" would allow for differentiating a single category of securitisation, with a unique regulatory treatment, or
3. A combination of both, where a securitization transaction could be considered as "*qualifying*", while the regulatory treatment of each tranche would follow a risk-based approach (i.e. for LCR purposes, only the senior tranche of a qualifying securitisation would be eligible, the same for the risk weight floor under the capital requirements, whilst the risk weights applicable to the non-senior tranches of a qualifying securitisation would also incorporate the seniority and credit enhancement level).

The EBF supports the combination of "qualifying" and "differentiated risk-based approach" (the third approach). In any case, the binary approach is not an option that achieves the objectives pursued as it would only apply the benefits of qualifying securitisation to the most senior tranche leaving the rest (thus their underlying assets) unattractive and mostly uneconomical.

Qualifying securitisations and consistency

We welcome the official position on taking a holistic perspective on the securitisation related issues in Europe, including the high quality securitisation debate. Consistency across regulations (Solvency II versus CRR) or within a regulation for different asset classes (securitisation against covered bonds within the CRR) should be properly considered.

An EBF proposal for the revised prudential framework of securitisations

The current revision of the prudential securitisation framework of the Basel Committee will frame the regulatory environment of the securitisation market. The standards established by the BCBS will have a critical influence on the 2 stages of the securitisation cycle: Firstly, the revised framework will determine the economic sense of origination at banks and, secondly, it will set the conditions for banks as investors. The new framework should pose an incentive for banks to originate and make it attractive for banks to invest in their own vehicles to ensure the tradability of securitised transactions among banks and other investors in the marketplace.

Defining a "qualifying securitisation" as being a "security where risk and pay-offs can be consistently and predictably understood" could be contemplated. However, for the sake of clarity we would prefer the following definition:

"A quality qualifying securitisation is a sustainable, simple and transparent transaction that tranches a portfolio of sustainable low-risk underlying assets".

In addition, a high quality qualifying securitisation is a tranche of a qualifying securitisation that is sufficiently senior to be robust.

– The regulatory regimes should mirror the policy objectives presented above; a qualifying securitisation should be assessed in a way that is compatible with policy objectives. **At a**

minimum, the regulatory regime should not discourage either types of qualifying securitisation. Moreover, the regulatory regime should encourage them (originators to issue them and investors to invest in them).

- The high level principles included in Box 3 encompass principles related to *simplicity, structural robustness and transparency* of the qualifying securitisations (in accordance with point 126 of the discussion paper). Our proposal consists in six principles for judging criteria for defining qualifying securitisations:
  - Supporting the **(1)** ***simplicity*** and **(2)** ***transparency*** principles;
  - Enhancing the structural robustness principle into **(3)** ***safe securitisation*** principle; and
  - Considering three additional principles: **(4)** ***regulatory governance principle***, **(5)** ***sustainability principle***, and **(6)** ***objective statistical basis principle***.
- We propose a principle-based approach for defining a qualifying securitisation and support the use of the Conservative Monotone Approach (CMA) for assessing the target attachment point that a tranche should at least have to be sufficiently senior. This proposal is consistent with the combination of "qualifying" and "differentiated risk based approach" as presented above.

The EBF supports the use of a principle based approach developed by the industry, known as the Conservative Monotone Approach[11] (CMA), which has been proposed in the EBF response to the Basel Committee consultation on revisions to the Basel Securitisation Framework[12].

The EBF would propose the use of CMA as an alternative to ratings for the following reasons:

- The CMA enables the definition of a 'safe tranche' based on a sufficiently high attachment point with no more reliance on external ratings.

- The CMA would limit the impact of sovereign contagion on capital requirements and other cliff effects of financial regulations due to automatic *en-masse* downgrades in tranche ratings and rating caps. Such downgrades have hampered bank funding and the financing of the economy in some countries notably those whose rating is no longer AAA.

- The CMA would reduce the negative effect created by the unpredictability in rating agencies methodologies and associated rating volatility on capital requirements. The need to re-rate to obtain regulatory approval solely because of changes in criteria is eliminated.

- The CMA would reduce the incidence of forced sales in crisis periods not driven by changes in collateral quality, but driven by sudden changes in capital requirements.

Do respondents think that a liquid market for 'qualifying' securitisations used for

[11] For details on the CMA and its calibration, refer to the paper "Calibration of the Conservative Monotone Approach and Regulatory capital for Securitisations", March 2014.

[12] Available at http://www.ebf-fbe.eu/wp-content/uploads/2014/03/EBF_007396-EBF-response-to-BCBS-2nd-consultation-on-Revisions-to-Securitisation-Framework.pdf.

funding would result from a 'qualifying certification'?

A qualifying certification would contribute to increasing the liquidity of the qualifying securitisations. Nevertheless, it is just one more initiative but it cannot be considered the solution to all problems.

These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?

The regulatory sense of certification

There is a risk of removing the economic rationale of vehicles left out of the certification criteria. It is important to assess the type of transactions that would typically fail to comply with all the conditions set as well as their concentration by country, sector, risk profile and other characteristics that should not determine themselves the eligibility of transactions.

It is important to consider the costs associated with the regulatory process that the certification will require. The additional compliance requirements could lead investors or originators to turn away from the product – especially if alternative investments can be found which are free of such burden.

Therefore, if a certification process is put in place it will need to strike a balance between:

– The credibility of certified products;

– The complexity of the process itself;

– The breadth of transactions that could be certified.

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

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

Ultimately, the absence of certification would surely give rise to unofficial lists of 'qualifying securitisations'. Such a situation will compel regulators and supervisors to intervene by making public statements. Keeping aside does not seem to be a plausible option in the future.

The EBF preferred option

The EBF is of the view that a certification mechanism should be considered to ensure a unique and transparent interpretation of the principles included in the definition of qualifying securitisation, and thus help rebuilding trust. A credible independent certification, that provides an accurate assessment in an efficient way and in a short period of time, and that is freely available in a single location, would undoubtedly promote operability and liquidity of these transactions.

To achieve this goal, we are of the opinion that a workable framework could be to derive the daily work of certification, understood as solely assessing compliance with existing regulatory definitions, to a private sector entity, but subject to public sector control. Using an experienced private sector company as a certification agency instead of public sector direct certification, would entail some advantages, as is the fact that it could adapt quickly and be operational in a reasonable time frame, it could be easily scalable to attend changing market requirements and it could charge the service offered to the market in an efficient and transparent way.

Nevertheless, public sector involvement could be complementary as it is the one that has the last word when interpreting the regulatory definition; for instance, assisting the certification agency in any issue of interpretation or when the issuers or investors do not agree with the work of the certification agency. The convenience of the presence of public sector representatives in the decision bodies of the certification agency and the surveillance of its governance arrangements could also be considered.

We think that PCS is in the best position to play this role of certification agency in Europe due to its ample experience in labelling high quality securitisations and solid reputation. Besides, its corporate structure, internal code of conduct and the fact that it is a 'not-for-profit' entity ensure the absence of material conflict of interest. However, some conditions should be established for a private-sector entity like PCS:

- It should be clear that any private sector entity that performed a certification task in the context of 'qualifying securitisations' should not have the power or the authority to modify the definition of its own volition. The task it would perform is solely to certify the existing regulatory definition or definitions. To the extent that any issues of interpretation arise, such issues should be subject to discussion and agreement with the relevant regulatory authorities and should not, other than in very trivial cases, be determined by certification agent.
- Obvious as it may appear, certifications do not replace regulations. Any originator or investor who did not agree with the work of the certification agent should be able to ask for a definitive ruling from the relevant regulator.
- A good template for such a model would be the STEPS program used by the European Central Bank to validate eligible commercial paper for its repo operations. The European Data Warehouse would be another good example of a private sector entity performing a regulatory role.
- To avoid a private sector entity from falling prey to conflicts of interest, any certification agent should be independent. It should not be owned or controlled by banks or other participants with an interest in the outcome of the certification. Its governance should be

transparent and possibly have some involvement from regulatory and public sector bodies.

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

Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?

All qualifying asset classes should provide loan level data. The European Data Warehouse, supported by their shareholders is actively promoting better data quality and accessibility.

We believe in the benefits of harmonisation and standardisation. However, at least for specific types of securitisation, current market standards have already improved significantly, including data availability by service providers such as Bloomberg, Intex, rating agencies and others.

In general terms, most value to investors would be added if harmonisation is provided on performance data (for example default, as well as gross loss and net loss definitions on granular transactions in various countries).

Moreover, for a new SME high quality securitisation segment, data availability and harmonisation could nevertheless still further improve. A hurdle to loan-level data is certainly the cost involved with assessing the data pool as well as the complexity of the data itself (data assessment and aggregation requires lot of time and capabilities). Performance indices as mentioned in paragraph 107 could be very useful to underline the high quality aspects of a "qualifying securitisation" segment.

Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?

Requiring disclosure to Prospectus Directive standards is unnecessary and could restrict participation in the European securitisation markets by non-European investors. We support harmonised disclosure standards agreed upon by the Basel Committee and implemented in a globally uniform way.

Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers

be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?

While we are in favour of facilitating investors access to all information required to assess risks and returns of ABS, we believe that, prior to broaden the sources of information available to investors, it should be considered what has already been achieved and the ongoing current proposals to increase transparency, in order to avoid duplications and ensure that usable information is provided in a cost-effective manner.

Since the crisis, several improvements in transparency have been implemented in Europe. The new prudential regulation – Article 409 of CRR[13] has incorporated a requirement for originators to make sure that investors have readily available access to all materially relevant data to carry out a comprehensive due diligence and effectively manage risks. Besides, it is undeniable the positive contribution in this regard of ECB and BoE transparency requirements for securitisation instruments which are eligible for repo facilities with central banks, and its catalyser effect on the establishment of the privately run European Data Warehouse, that is a valuable information source for European securitisations with a scope that is widening from day to day.

We would also point out that there are currently in Europe ongoing public initiatives to promote greater ABS transparency, which should not be dismissed, as is the case of the forthcoming increased disclosure requirements for securitisation, as mandated by Article 8b of CRA[14], for investors to make informed assessments on the creditworthiness of structured finance instruments and reduce reliance on credit ratings.

Consequently, in our opinion it does not seem necessary to consider the access by investors of an additional information source, as would be the case of credit registers, also taking into account the legal difficulties that can generate the public access to them, mainly associated with the compliance with no harmonised data protection laws, for instance in relation to the preservation of borrowers confidentiality rights.

In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

[13] Regulation (EU) No 575/2013 (Capital Requirements Regulation).

[14] Regulation (EU) No 1060/2009 (Credit Rating Agencies).

For most active securitisation markets, rating agencies and (investment) banks publish comprehensive accumulated data derived from the investor reports of outstanding transactions. Further standardisation of these investor reports may help improve the aggregated data. Aggregate data for all assets of a certain asset class (whether or not securitised) show minimal deviations from the data on the securitised assets. However for newly re-emergent asset classes (like SME securitisation) aggregate market data may be useful as long as insufficient data on securitised pools are available. In this area, there would be a role for national competent authorities to collect and publish these statistics, as an independent source of information.

In our view, data availability has improved massively and is no longer the main cause for a muted secondary market. Secondary market functioning can be further supported by data availability but the real cause for low activity is limited availability of assets from bank balance sheets for new transactions, i.e. limited supply of existing and new bonds. Most investors have visibility to all important macro data - via research services and information providers such as Bloomberg. However standardised trading and credit data on a broader scope can be helpful to improve accessibility in particular to standardised and prepayment rates, call date accessibility, call history, expected loss metrics and recoveries. Other data by banks, such as non-performing loans (NPL), could be considered as well. Nevertheless, expensive expertise (human resources) and modelling software such as Bloomberg or Intex could represent a challenge for market participants.

Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

The current fragmented nature of the European market, with different characteristics of transactions coming from different jurisdictions, dilutes the benchmark concept. Benchmark indices for certain asset classes might gain value in a more standardised environment and only when the market returns to the volumes seen in the past.

With reference to paragraph 116, we would see active and consistent ABS indices as useful instruments. One has to distinguish between performance related indices on the one hand and price or spread indices on the other. The former indices, which are benchmarking credit risk, are already used by different rating agencies and can be produced relatively easy. The latter indices could support trading or allow for hedging. However, these indices are difficult to be created since transactions are not very standardised and, if there is not enough market acceptance, trading and index levels could be misleading. In the past, there have been a number of private efforts to create tradable indices in Europe for specific securitisation asset classes like CMBS or RMBS (e.g. by Markit) but these efforts failed to become market standards. In general the lack of sufficient transactions makes it difficult to set-up tradable indices, but this is nevertheless possible and desirable for a high quality standardised segment it. Indices are particularly useful if consisting of a broad range of comparable instruments. Selected spread benchmark curves (non-tradable but indicative) would also be useful as a comparable benchmark tool.

Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

We consider important that credit rating agencies (CRA) are encouraged to publish additional information, as the matrix suggested, to complement heading ratings and help investors assess the effect on ABS ratings of sovereign and counterparty caps, included in the rating methodology of several agencies.

CRA transition matrices represent a valuable source of risk information that should be used for supervisory monitoring purposes notably in the realm of macro-prudential supervision.

We understand that it is agencies' prerogative to decide on the methodology to be used to assess risk. Likewise, it is prerogative of the authorities to use those ratings in regulation or introduce certain corrections to them to achieve their objectives, deserving special attention the mitigation of systemic risks and the consolidation of the banking union to help alleviating the banking-sovereign risks feedback.

In the case of ABS rating, we consider that certain practices followed by credit rating agencies are questionable and give rise to potential systemic risks. This would be the case of the practice of constraining ABS ratings by the rating of the corresponding sovereign, which could deter ABS issuance in stressed economies, preventing the viability of a complementary channel to finance real sectors when most needed. We consider that this practice may induce double counting of risk, if country risk is already and adequately being captured in the credit risk assessment of the pool and third parties to an ABS transaction.

Following this, we would recommend going beyond encouraging additional information, to establish a mandatory disclosure, for credit rating agencies assessing ABS, of the rating in the absence of the sovereign ceiling. Besides providing more transparency for investors, allowing them to filter out the sovereign cap if they wish to do so, it would enable regulators to consider this rating as the reference in regulation instead of the currently considered heading ratings. This would help to neutralise the negative effect of the raise of capital requirements of ABS with underlying assets located in stressed countries irrespective of their over-collateralisation, largely due to rating agencies practices that translates to ABS ratings the sovereign ratings' downgrades. Moreover, this would help moving towards the overall objective of the global regulatory reform of reducing mechanistic reliance on credit rating agencies.

Central banks could take the lead in this direction, referencing to these uncapped ratings the haircuts applied to repo operations with ABS.

How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall

outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

We share the analysis of the several constraints that could have an impact of reducing excessively the availability of counterparties eligible to provide ancillary services to an SPV, being one of the most relevant the rating requirement.

The paper focuses on exploring the use of bank accounts that legally fall outside the insolvency status of their provider, thereby enabling more counterparties to be able to provide them to SPV. One of the ways to achieve the goal could be to change national insolvency laws to establish a preferential treatment for SPVs in relation to bank accounts, which could have a beneficial impact but possibly of moderate quantitative relevance. Other possible ways to explore, as outsourcing of certain ancillary services (swap counterparties and bank accounts), could be considered, but only if subject to conditions that are supported by written clauses and activated by triggers related to the deterioration of the insolvency of the provider. We would fully discourage the consideration of a mandatory and unconditioned outsourcing of these services because it would be unnecessarily costly and would not prevent systemic risks as those services, once externalised, would be covered mainly by banks.

With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?

An overarching point of attention is the alignment of capital and liquidity requirements for securitisations, covered bonds, whole loan purchases, etc. Convergence of the regulatory treatment of the various instruments is essential to the revival of the securitisation industry.

As regards the definition of qualifying securitisation, there are 3 complementary and additional principles that would be worth considering:

Regulatory governance

In our opinion this principle is extremely important for certifying the soundness of the qualifying securitisation and the proper application of the other five principles. Thus, *the control parameters should permit regulators to achieve their objectives and exercise judgment in assigning the qualifying securitisation and high qualifying securitisation labels across types of exposure.*

There are multiple topics which should be under regulatory scrutiny, as the following:

1. Regulation of the origination of the underlying assets by regulators using and defining qualifying securitisation for setting responsible lending rules;
2. Regulatory control for risk measures used to define qualifying securitisation;
3. Regulatory control for the numerical parameters of any risk formula used in assessing them;

4. Regulatory control of the certification process for qualifying securitisation by regulating the independent gatekeepers for the high quality securitisation label;

5. Static (at inception) high quality securitisation label or dynamic control (with a frequent assessment of its validity) to be set forth by regulators.

The concept of independent gatekeepers is similar to using external auditors to validate the accounts prepared by the company accountants. Private labels like PCS, Rating Agencies, Central Banks, Competent External Auditors or Law Firms could be such gatekeepers.

- Rating agencies could provide a label in addition to an external rating, as long as they are regulated by ESMA. However, this will lead them to admit that there are different qualities of AAA;

- Private label as PCS or TSI could be used (need to be regulated);

- National central banks could approve post-closing a label (such as approval process for ECB Eligibility – however the process would be driven by the jurisdiction of the underlying assets, not by the jurisdiction of issuance);

- Competent External Auditors or Law Firms could also be authorised to determine an HQS label.

While the above independent gatekeeper options illustrate what we mean for Regulatory Governance, the "EBF preferred option" has been presented earlier in this paper.

Sustainability

By developing a sustainability principle, we seek to formalise the notion that asset classes that are subject to instabilities associated with market price effects should not form part of the QS category. Moreover, <u>both</u> *the underlying assets* should be sustainable <u>and</u> *the securitisation market for such underlying assets* should be sustainable.

By definition, sustainable assets are real assets (no synthetic underlyings) and the underlying assets should be not marketable, and therefore the securitisation will provide the primary funding source as a marketable instrument.

For a securitisation transaction done for funding purpose, according to the definition above underlying assets that are sustainable are for example:

- Residential mortgage for an owner-occupier;

- Residential mortgage with-recourse for a buy-to-let property;

- Consumer loan;

- Credit card;

- Auto loan or an auto lease to purchase or lease an automobile;

- Corporate trade receivable;

- Infrastructure loan;
- Aircraft or shipping loan;
- Export finance;
- Corporate loan whose purpose is to finance an investment (typically SME loan).

For the same type of transaction, the analysis of the sustainability of the underlying assets depends on more detailed characteristics of the assets; for instance

- A corporate loan whose purpose is to refinance existing debt is sustainable if the debt is arriving at maturity (typically, Real Estate loans) and is not sustainable if the refinancing is done as an early repayment based on market conditions (as demand for the asset will stop when spreads widen)
- A corporate loan whose purpose is to distribute exceptional dividends is not sustainable (typically, certain types of leveraged loans) because the demand will stop during downside of cycles.

The sustainability principle, coupled with history of low credit risk through time requirement for underlying assets (according to the safe securitisation principle) and “Responsible Lending Rules” or equivalent requirement would allow to provide a framework for identifying what types of underlying assets fit within the label framework in a consistent manner across asset classes, over time and across regulations or private initiatives such as EIOPA definitions of high qualifying securitisation, PCS or Central banks’ eligibility criteria (which uses different lists of eligible assets and where asset classes are eliminated in a variety of ways).

For the securitisation market to be sustainable, the underlying assets should be illiquid and not marketable individually on the capital markets. The securitisation will provide the ‘primary’ funding source on the capital markets.

If an individual bond or ABS or tradable loan is individually marketable on the capital markets, those instruments can already get their primary funding from capital markets investors. A securitisation of such underlying instruments becomes often ‘an arbitrage transaction’ whose main aim is to extract margins, not to provide funding for the underlying assets. The funding provided to the underlying assets is a side effect of the transaction; it is on a ‘secondary’ basis. The securitisation market will stop completely the moment the margin extraction cannot occur at a profit:

- According to the sustainability principle, the securitisation market for ‘CDOs of ABS’ is not sustainable, as the underlying ABS are already liquid and tradable on the capital markets.
- Balance-sheet Corporate Securitisations are sustainable, as both the underlying assets and the securitisation market are sustainable. A typical example would be SME loans.

As regards synthetic securitisations, we question the statement that generally synthetic forms of risk transfer are necessarily more opaque than cash forms (end of point 96 in the discussion paper) as such synthetic forms could actually include transactions where the risk transfer is effected not through the use of derivatives but rather through cash collateral or financial guarantees. We would therefore suggest extending the scope of structures allowed (from section 135 of the discussion paper) at least to those using cash collateral as a credit enhancement, as these structures could comply with the definition of 'qualifying securitisation' as the ones 'where risk and pay-offs can be consistently and predictably understood'.

Objective Statistical Basis Principle

According to this principle, any risk measure used in a high quality securitisation definition (e.g. a rating or a formula-based risk measure) should be based on a clear, objective statistical measure of risk.

This principle implies that the choice of the risk measure needs to be aligned with the regulatory objectives. The external ratings (either Probability of Default or Expected Loss of the tranche), which are not regulatory parameters are poor-proxy for a high quality securitization label. In addition, they are not stable risk measures. The Unexpected Loss is a regulatory measure, expressed as a risk weight and provides a stable risk measure for securitisation tranches (the CMA approach is based on unexpected loss). Therefore, regulators will be entitled to define the values of the regulatory parameters to use to enable users to assess if a qualifying securitisation tranche is sufficiently senior (this point is detailed hereunder).

Using the Conservative Monotone Approach for high qualifying securitization:

As indicated above, we propose a complementary approach for the principle-based approach for defining a "qualifying" securitisation the use of the Conservative Monotone Approach (CMA) for assessing the target attachment point that a tranche should at least have to be 'sufficiently senior'. The CMA and the principle-based approach for definition defining a "qualifying" securitisation are complementary in supplying a substitute for agency ratings in some regulatory applications. Agency ratings embody both quantitative analysis of the degree of conservatism in the tranching of the deal given the nature of risks in the underlying securities and qualitative analysis of the deal. Correspondingly, the CMA and the high quality qualifying securitisation principle-based approach would cover, respectively, quantitative and qualitative aspects of high quality qualifying securitisation evaluation. In addition, the CMA provides a measure of total loss (UL+EL) rather than EL which is what ratings aim to identify (at least Moody's style ratings, S&P/Fitch ratings focus on PD).

The formula does not rely on ratings[15]. It requires regulatory control, with the parameter $CSSF_M$ (capital surcharge scaling factor) and $\rho^*{}_M$ (conditional pool correlation). In Europe, regulatory control could be exercised in the different jurisdictions by the national central banks who are best equipped to assess the risks of their national assets. (e.g. Banque de France is best equipped to assess French mortgages, Banco de España is best equipped to assess Spanish SMEs…). A central supervisory process (such as the ECB and the BoE; or the EBA) would then validate the proposed numerical values $CSSF_M$ and $\rho^*{}_M$.

[15] Detail of the formula is equation A2.33, page 30, in "Calibration of the CMA and Regulatory Capital for Securitisations" (April 2014).

Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

It is important to consider the wider regulatory policy toolbox when assessing the impact that a new element will create on stakeholders and the underlying economy. Once the terms for qualifying securitisation are defined, it follows that it should be used in several parts of the current regulatory framework including:

- For regulatory capital purposes: Qualifying securitisations could have a flexible regulatory floor instead of the one-size-fits-all floor currently proposed in the Basel Committee consultative paper of 15%. The EBF proposal is to apply a floor of 5% plus 10% of the risk weight under standardised approach. This would be a major improvement in the current regulatory framework. Under current proposals the capital for a large fraction of securitisation tranches will be determined by a binding floor which is insensitive to risk. That is an impediment for investors irrespective of the informational benefits of the label.
- Benefits in Liquidity Coverage Ratio treatment: A broader class of qualifying securitisation tranches could be made eligible for the short-term liquidity ratio (LCR).
- Benefits in the regulatory framework of investors: It would make sense to modify the current EIOPA Solvency II proposals to coordinate with the qualifying securitisation definition that is developed for banking regulatory purposes.
- Better haircut in central bank collateral rules: It would make sense to modify current ECB rules to coordinate with the qualifying securitisation definition that is being developed for banking regulatory purposes.

Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?

Some benefits mentioned in section 2 might also be reached via alternative instruments which are closely related to securitisation. For example, covered bonds could play also a role in SME funding. Project bonds could play a growing role in infrastructure funding, at least in the some countries which suffered most the financial crisis, with project related benefits for the SME sector. These instruments could be both a funding tool to support real economy lending by banks and non-banks as well as investment instruments for banks and non-banks, insurance companies and pension funds, as outlined in section 2. Nevertheless, the costs related to such bonds appear to be relatively higher than for plain vanilla ABS and the investor base, particularly for SME covered bonds, is thin (only one comparable instrument was placed in the market, with core SME loans in the pool).

Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?

Concerning the involvement of external parties, we consider that the required independent credit assessments by at least two credit rating agencies is not strictly necessary. The requirement should be established for only one rating, as is the case in the US, reducing thereby issuance costs and recognising the greater emphasis on due diligence that has to be conducted by investors.

Another additional principle that could deserve being included is a limitation of the maturity mismatch to prevent an excessive exposure to refinancing risk.

Finally, we support the general principle of exclusion, at the time of issuance, of non-performing loans but we consider that this principle should be understood in the sense that underlying loans and receivables should not be in default, as defined in the prudential regulation in order to achieve consistency and promote harmonised implementation. This approach to relate non-performing loans with prudential definition of default has already been taken by EIOPA for its recommendations for type A securitisations under Solvency II.

To:

The Bank of England and

The European Central Bank

4 July 2014

Dear Sirs,

I write in response to your Discussion Paper "The case for a better functioning securitisation market in the European Union" dated May 2014 henceforth referred to in this letter as the Discussion Paper.

We very much welcome the opportunity to comment and we consider the Discussion Paper to be well researched, constructive and a positive initiative for the rehabilitation of the European Structured Finance/ABS Markets and therefore an aid to stimulating economic activity and growth in the European Union.

Our company, EuroABS Limited, has provided independent services relating to the provision of data, analysis, technical expertise, surveillance and information to the Structured Finance (SF) Industry and its investor community for fifteen years.

EuroABS' range of European Securitisation Market products and services includes:

- EADReD – comprehensive database of European ABS prospectuses and investor reports (everything publicly issued since 1995, 6,000 issues) provided free of charge to all market participants
- Broker/dealer contributed valuation
- Position monitoring and surveillance
- Issuer regulatory compliance and reporting

Recently EuroABS has acted for SF issuers to help with their Bank of England (BoE) DWF compliance requirements. EuroABS has successfully acted for SF issuers on a dozen or so occasions (we are currently working on several such transactions) providing:

- BoE compliant Cash Flow Models (or Liabilities Only Waterfall Models as described in our response)
- Help with the production and submission of BoE and ECB template compliant loan level data
- Checking of loan level data (ensuring static data fields are consistent across periodic data files and 'sanity checking' data values in line with reasonable expectations)
- Checking of loan level data against contemporary investor reports
- Secure hosting of these documents, models and data

Please see our response to your Discussion Paper below.

Yours faithfully,

Ben Bates (CEO EuroABS Limited)

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Executive Summary

- EuroABS agrees with the "Principles of a 'qualifying securitisation'" set out in Box 3
- EuroABS considers that liabilities only waterfall cash flow models provided by the issuer are an essential component of any 'qualifying securitisation' requirement.
- EuroABS disagrees with ESMA in the removal of the requirement for issuer supplied cash flow models from the recently released final draft of the CRA3 RTS and EuroABS also disagrees with the reasons cited by ESMA for this exclusion.
- EuroABS submits that it is imperative for the long-term health of European Securitisation Markets that all regulatory required information be free and available to all that need it. Transparency and the stimulation of competition in credit assessment work in these markets will drive up standards and drive down costs.
- EuroABS submits that it already gives all market participants free access to a complete database of all prospectuses and investor reports via its website.
- EuroABS has processed most of the loan level data made available by UK RMBS issuers through BoE eligibility compliance and has produced some high level index statistics freely available to all via its website. EuroABS is looking to develop further indices and is already working on the processing of data for other asset classes.

EuroABS Response

EuroABS' interest and expertise with respect to the Discussion Document is primarily related to transparency and disclosure of transaction information.

As noted in our covering letter above, EuroABS has accumulated significant experience in helping UK issuers comply with Bank of England eligibility requirements[i]. We consider every item in these requirements to be important and the overall standards to be fair, balanced and achievable for public exchange registered securitisations. In short we consider these to be the Gold Standard for public ABS issuance transparency and disclosure requirements.

As a non-participant in the buying and selling of securities, it is not for EuroABS to comment on all of the content and questions within the Discussion Document, however we are keen to submit answers to the following questions for your consideration:-

The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

Cash Flow Models

With regard to the principles in Box 3, EuroABS would like to specifically comment on the importance of the provision by issuers of liabilities only cash flow models. EuroABS considers that these models should be a requirement for any 'qualifying securitisation'.

EuroABS submits that there are two distinct parts of a cash flow model for a securitisation transaction:

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1. an asset cash flow engine – that is to say the interest and principal cash flows generated by the assets underpinning the securitisation and
2. the liabilities waterfall – the rules as to how the interest and principal cash flows are allocated amongst the various beneficiaries.

Part 1 is subjective and needs to be the responsibility of the user of the model. Part 2 is objective, the mathematical model for which, EuroABS considers, the issuer should provide.

The Bank of England (BoE) stipulates the liabilities only waterfall model as a component of its DWF eligibility requirements. ESMA also defines a liabilities only waterfall model in its CRA3 RTS Consultation Document[ii]

N.B. References to Cash Flow Models (or CFMs) from this point in the document forward are to 'liabilities only' waterfall cash flow models.

Our experiences of working on the production of BoE compliant Cash Flow Models have been interesting and enlightening.

Dr Stephen Walker, EuroABS Head of Technology comments:
"Although the basic principle of a pass-through cash flow model is very simple – money passes into the model and is sequentially prioritised between a set of demands until there is none left – the actual implementation in modern ABS transactions can result in complex and subtle behaviour. This derives principally from measures intended to provide liquidity support or credit enhancement. Typically, a transaction will contain one or more funds intended to achieve these objectives. These may be pre-funded to some extent by the issuer, and are topped up when possible from the cashflow. The rules determining how and when and to what extent they are used and replenished vary in nature and complexity depending on the intentions of the issuer. Frequently their effect is to strengthen the subordination of the notes by allowing the senior notes to borrow cash from subsequent periods which is then re-credited ahead of the junior notes. A similar effect is exhibited by the common mechanism of providing liquidity support using a "principal to pay interest" feature. This typically relies upon a set of principal deficiency ledgers which records the use of the feature. Typically there is a ledger for each class of notes, with debits recorded from the bottom (least senior) up and credits from the top down. Again, there is an element of strengthened subordination in addition to the priority of payments, and again the rules for the use of principal to pay interest vary in their complexity.

One effect of these measures is that it is difficult to assess the cashflow in any particular scenario merely by inspecting the waterfall documentation – there is too much complexity, and too much dependence on the state of previous periods. A quantitative analysis is necessary. It is also the case that an issuer approved cashflow model necessarily removes any ambiguity in the interpretation of the documentation. In this sense, a properly explicit model which makes every working part of the cashflow waterfall open to inspection provides a definitive mathematical interpretation of every feature of the transaction."

On several occasions we have found documentation to contain ambiguity that requires clarification by the issuer[iii].

Also seen are instances where the documentation has contained circular references. As a result of the cash flow model building process these have been exposed, flagged up with the issuer, then referred to the originating legal team and subsequent documentation amendments sent to investors for approval.

As such, we consider that a final independent documentation check resulting in the structured finance (SF) issuer standing behind a mathematical model representing the behaviour of the cash flows and allocation of funds to beneficiaries given a set of user defined inputs to be an essential transparency and disclosure requirement for any securitisation that falls into regulatory scope.

We consider it important that the cash flow models (CFM) provided by the Issuer should be 100% transparent to ensure that the cash flows can be followed through every constituent part of the issue structure and cash waterfall.

To this end we consider that the CFM should be provided in a self-contained file format (such as open office Excel) with every component and piece of calculation code visible and available for inspection. EuroABS considers that use of obscured "black box" function or, perhaps, opaque "server side" components - that could leave models vulnerable to error and impossible to accurately audit with certainty – should be avoided.

EuroABS consider it important for the clarity of everyone involved in the transaction that a liabilities only waterfall CFM is provided by the issuer, along with all other transparency requirements, free of charge.

Cash Flow Models ESMA and CRA3

In addition to the above points on CFMs, EuroABS notes that the European Securities and Markets Association (ESMA) in its final draft of CRA3 RTS[iv] have removed issuer supplied CFMs as a requirement. EuroABS are unable to agree with the reasons given, here addressed as follows:

ESMA citation: "cash flow models are already provided on a large scale by data providers such as Bloomberg"

EuroABS response: It is true that there are several third party commercial cash flow model providers. They are popular and do a great job, however feedback from users that have tested models supplied by different providers for identical transactions is that not all models provide identical output given identical inputs. This therefore begs the question "which model is correct?" Without an issuer approved model, to which everyone has free and equal access, this question cannot be adequately answered. Clearly, this would be a particularly important issue to resolve if a transaction were to become distressed. We therefore submit that it is important for regulators to require an issuer supplied model at the point of primary market issue.

ESMA citation: "[models] are costly [to provide]"

EuroABS response: Recent market rates for the required work for BoE compliance cash flow modelling have been between four figures and very low five figures GBP. We accept that whether this is considered expensive or not is a subjective point, but we submit that, per transaction, law firms, rating agencies and investment banks require fees that are typically in the mid six figures upwards each. In this context we consider the additional CFM cost to be reasonable. We also consider that the benefits to the investors and the market (as described in this response) of the issuer-supplied CFM significantly outweigh the cost.

ESMA citation: "[models are] complex for market participants to provide"

EuroABS response: If the transaction is too complex for the issuer to provide a CFM, EuroABS submits that it would appear unlikely that it could be considered "simple" and "transparent" - clearly two of the high level cornerstones of a "qualifying securitisation" as defined by the ECB and others – and should not be considered eligible.

Should issuers really be allowed to sell securities into the market that they themselves can't model?

ESMA response: "As suggested by some respondents, in view of the potential conflicts of interest inherent to the disclosure of cash flow models provided by the issuer…"

EuroABS response: EuroABS does not agree that issuers are conflicted in these circumstances – is it possible that ESMA has, in its reasoning, considered the inclusion of the 'asset cash flow generation engine' (subjective, as explained above) as opposed to the liabilities only waterfall model (objective and as defined in ESMA's own CRA3 Consultation Document) and become confused?

EuroABS submits that the CFM task as defined is 100% objective and it is therefore not possible for an issuer to be conflicted in this undertaking.

ESMA response: "ESMA has amended its proposal and removed the cash flow model from the draft RTS on grounds that cash flow information will be accessible to investors in the required transaction documents (among others as part of the information on the waterfall of payments of the SFI and the investor reports)."

EuroABS response: We agree that cash flow information is provided in the required transaction documents, but consider that the points raised above - explaining how an issuer-supplied cash flow model deals with the opacity, ambiguity and complexity of the transaction - justify the inclusion of an issuer-supplied cash flow model as a requirement.

Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?

Access to all regulatory required information should be free of charge to give fair and equal access to all parties. EuroABS considers this as essential for the promotion of competition in the surveillance/credit assessment/data processing/credit ratings field (a clearly stated objective of several European regulatory bodies).

Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?

EuroABS provides (inter alia) prospectuses and investor reports free of charge to all market participants on its website at http://www.euroabs.com (as described in covering note above).

Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

EuroABS has processed most of the loan level data made available by UK RMBS issuers through BoE eligibility compliance and have produced some high level index statistics freely available to all via its website here: http://www.euroabs.com/MarketIndices.aspx. EuroABS is looking to develop further indices and is already working on the processing of data for other asset classes. We look forward to receiving feedback on this work from market participants, central banks and other regulatory bodies.

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[i] http://bankofengland.co.uk/markets/Pages/money/eligiblecollateral.aspx

[ii] See http://www.esma.europa.eu/system/files/2014-150_consultation_paper_on_cra3_implementation_0.pdf Annex 9 on page 131

[iii] Consider the following real example which will yield different results depending on the use of parentheses in the text:

- will be an amount equal to 3.3 per cent. of the Principal Amount Outstanding of the Rated Notes as at the Closing Date minus the amount standing to the credit of the Class A Liquidity Reserve Fund Ledger"
- "will be an amount equal to **(**3.3 per cent. of the Principal Amount Outstanding of the Rated Notes as at the Closing Date**)** minus the amount standing to the credit of the Class A Liquidity Reserve Fund Ledger"
- "will be an amount equal to 3.3 per cent. of **(**the Principal Amount Outstanding of the Rated Notes as at the Closing Date minus the amount standing to the credit of the Class A Liquidity Reserve Fund Ledger**)**"

[iv] http://www.esma.europa.eu/system/files/2014-685_draft_rts_under_cra3_regulation.pdf Page 13 paragraphs 23 and 24

The Bank of England,
Threadneedle St,
London, EC2R 8AH

26 July 2014

Dear Sir

I write with regard to the concept of 'qualifying securitisations' which I believe is currently under consideration by European regulators and Central Banks.

There are many criteria and details to consider on this subject, however, the points I would like to raise pertain exclusively to requirements for securitisation issuers to provide 'cash flow models' (or indeed only the ***Liabilities Waterfall Model*** element of the cash flow models as explained below) for their transactions. I hope that I may be able to provide clarity where I perceive ambiguity has crept into terminology and suggest definitions that I hope will prove useful. I hope also to be able to provide some insight into our work in the production of ***Liabilities Waterfall Models*** and to illustrate and justify the importance of such models as a fundamental requirement within any set of securitisation or structured finance regulatory transparency standards.

Summary

- The term '***Cash Flow Model***' has become ambiguous and, in at least one important instance, appears to have caused confusion. The Market would be better served by the use of terminology such as: '***Asset Cash Flow Generator'*** to represent the subjective element, '***Liabilities Waterfall Model'*** to represent the objective element and '***Complete Cash Flow Model***' to represent both elements combined.
- Securitisation transactions are often complex. An instance of the issuer-provided ***Liabilities Waterfall Model*** should be available to all to eliminate ambiguity and facilitate clarity.
- EuroABS considers that the existence of an issuer-supplied ***Liabilities Waterfall Model*** should form part of a set of minimum standard tests for a 'simple' transaction.
- ***Complete Cash Flow Models*** from commercial providers represent a third party opinion. In the event of dispute over a transaction, an issuer-supplied ***Liabilities Waterfall Model*** would provide the all-important ultimate 'source of truth'.
- EuroABS considers that the Bank of England Sterling Monetary Framework Collateral Eligibility requirements for issuer-supplied cash flow models (or, as I have tried to define here, ***Liabilities Waterfall Models***) are sensible, well specified and demonstrably achievable and should be considered as the Gold Standard in these markets.

Our Business – EuroABS Limited

EuroABS Limited has provided services to the European Securitisation Markets for fifteen years[1]. Latterly, we have successfully acted for issuers on a dozen or so occasions as the supplier of services which enable Bank of England Sterling Monetary Framework Eligibility Compliance[2].

Cash Flow Model – Definition of Terms

It is first of all important to point out that the term 'cash flow model' used with reference to the ABS market over recent decades has not had an entirely consistent definition.

Normally, the term 'cash flow model' when referring to a third-party produced model provided on commercial terms[3], would consist of two quite distinct elements:

1. an ***Asset Cash Flow Generator*** and
2. a ***Liabilities Waterfall Model***

For clarity, I shall refer to these two elements in combination as a '***Complete Cash Flow Model***'.

The ***Asset Cash Flow Generator:*** generates future periodic principal and interest cash flows based on user assumptions. This element is ***subjective***.

The ***Liabilities Waterfall Model:*** allocates those future principal and interest cash flows to the various beneficiaries according to the terms described in the transaction documentation. This element is ***objective***.

Essentially, throughout the life of the transaction and at each future predetermined periodic interval, the asset pool underpinning the transaction will generate both an interest and a principal cash flow. These cash flows are dependent upon the future credit performance of the assets and are therefore unknown and impossible to quantify with one hundred per cent accuracy. In a ***Complete Cash Flow Model***, this process could be modelled by some form of ***Asset Cash Flow Generator*** which, typically, would accept a series of high level inputs, such as CPR (constant prepayment rate), CDR (constant default rate), etc[4]. These input opportunities are designed to give the user of the ***Complete Cash Flow Model*** a simplified interface that will accept asset-pool credit performance assumptions and output both interest and principal cash flows for each future period for onward input into the ***Liabilities Waterfall Model***.

Bank of England and ESMA Cash Flow Model Definitions

The Bank of England issuer-supplied cash flow model requirements are set out in Annex B of the 30 November 2010 Market Notice[5]. EuroABS has interpreted these requirements as the ***Liabilities Waterfall Model*** element.

ESMA, in Annex 9 of its 11 February 2014 Consultation Paper[6] (the originally proposed ESMA requirement), describes the then-proposed cash flow model requirement in very similar terms.

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[1] Please see our website http://www.euroabs.com for a full description of the EuroABS business and services.
[2] Service provision includes: secure web hosting of documentation and data, liabilities waterfall cash flow modelling, loan level data and investor report preparation and checking.
[3] e.g. as provided by Bloomberg or Intex
[4] There could be many of these depending on the sophistication of the Asset Cash Flow Generator and the type or types of assets in the pool.
[5] http://bankofengland.co.uk/markets/Documents/marketnotice121002abs.pdf

An identical quotation from both documents states: ***"The model should incorporate all features of the transaction which are not open to change or interpretation".***

Further to this, the work EuroABS has undertaken over the last few years in helping securitisation issuers to achieve Bank of England compliance has always resulted in:

- The production of a ***Liabilities Waterfall Model*** element only;
- Acceptance of the ***Liabilities Waterfall Model*** element by the Bank of England and
- Ultimate acceptance of the bonds as eligible collateral.

EuroABS therefore considers that it is justified in feeling comfortable about its interpretation of the requirements as a ***Liabilities Waterfall Model*** element only.

Liabilities Waterfall Model only or Complete Cash Flow Model

Our initial interpretation of the originally proposed ESMA requirement was the same as that of the Bank of England's in requiring the ***Liabilities Waterfall Model*** only. However, ESMA, in its Final Report on the Draft RTS under CRA3[7], removes the requirement for an issuer supplied cash flow model citing "***potential conflicts of interest inherent in the disclosure of cash flow models provided by the issuer***".

In order for any conflict of interest to exist in the requirement, there must be a subjective element in the specification. EuroABS therefore assumes that the originally proposed ESMA requirement must include the ***Asset Cash Flow Generator*** or indeed the ***Complete Cash Flow Model,*** although we have been unable to find reference to this in the documentation provided.

For the avoidance of doubt, EuroABS considers:

- the requirement for securitisation issuers to provide a ***Liabilities Waterfall Model*** only is sensible
- the requirement as defined by the Bank of England and ESMA is adequate, but could perhaps benefit from additional clarity on definition of terms and whether or not the ***Asset Cash Flow Generator*** element is required or not. EuroABS considers that, to avoid issuer conflict of interest and subjectivity in the issuer-produced model, the ***Asset Cash Flow Generator element*** should not be required.

Minimum Test for a 'Simple' Transaction

As to whether or not a transaction is 'simple' or not, we submit that an initial minimum standard test for transaction simplicity should be, at the very least, that the issuer is able to:

- model the ***Liabilities Waterfall Model***;
- provide a mathematical and/or computer code implementation of same and
- stand behind it

EuroABS Liabilities Waterfall Model Modelling Experience

Dr Stephen Walker, EuroABS Head of Technology comments as follows:-

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[6] http://www.esma.europa.eu/system/files/2014-150_consultation_paper_on_cra3_implementation_0.pdf
[7] http://www.esma.europa.eu/system/files/2014-685_draft_rts_under_cra3_regulation.pdf

"Although the basic principle of a pass-through cash flow model is very simple – money passes into the model and is sequentially prioritised between a set of demands until there is none left – the actual implementation in modern ABS transactions can result in complex and subtle behaviour. This derives principally from measures intended to provide liquidity support or credit enhancement. Typically, a transaction will contain one or more funds intended to achieve these objectives. These may be pre-funded to some extent by the issuer, and are topped up when possible from the cash flow. The rules determining how and when and to what extent they are used and replenished vary in nature and complexity depending on the intentions of the issuer. Frequently their effect is to strengthen the subordination of the notes by allowing the senior notes to borrow cash from subsequent periods which is then re-credited ahead of the junior notes. A similar effect is exhibited by the common mechanism of providing liquidity support using a "principal to pay interest" feature. This typically relies upon a set of principal deficiency ledgers which records the use of the feature. Typically there is a ledger for each class of notes, with debits recorded from the bottom (least senior) up and credits from the top down. Again, there is an element of strengthened subordination in addition to the priority of payments, and again the rules for the use of principal to pay interest vary in their complexity.

One effect of these measures is that it is difficult to assess the cash flow in any particular scenario merely by inspecting the waterfall documentation – there is too much complexity, and too much dependence on the state of previous periods. A quantitative analysis is necessary. It is also the case that an issuer approved liabilities waterfall model necessarily removes any ambiguity in the interpretation of the documentation. In this sense, a properly explicit model which makes every working part of the liabilities waterfall open to inspection provides a definitive mathematical interpretation of every feature of the transaction."

EuroABS Discussions with Investors

EuroABS interacts with investors in European ABS markets on a daily basis. We have frequently engaged investors in discussions related directly and indirectly to the subject matter above. One theme of the feedback we receive again and again could be summarised by the following:

> Whilst third party-provided commercial complete cash flow modelling services are regularly employed by the industry, they represent an opinion and may not be consistent across different providers. As stated by one experienced investment professional in a recent central bank discussion paper response: "we believe that issuer [Liabilities Waterfall] Models will be extremely important should deals come under any stress or in the event of a dispute, as they will represent the ultimate "source of truth".

Further communication on the above matters or any related would be most welcome. Please let me know if you would like to meet or discuss over the telephone.
Yours sincerely

Ben Bates
CEO EuroABS Limited

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European Central Bank
Bank of England

Document submitted via email

July 4th , 2014

Re: Consultation Paper on the Case for a Better Functioning Securitisation Market in the European Union

Dear Sirs,

we welcome the opportunity to comment on the discussion paper published. As you will appreciate, we believe it is of paramount importance a capital requirements framework both fair and consistent with the quality of the assets it applies to.

We also believe that laying out a standard for qualifying / high quality securitization would improve the market. To this extent, we recommend building on the principles you defined in Box 3; however, we also provide a set of criteria that we believe would help address both the risks stemming from the assets' quality and those deriving from the structure's complexity level.

The following pages report specific responses to selected questions.

We are happy to answer any further questions you may have.

Yours sincerely,

EUROPEAN INVESTMENT FUND

Alessandro Tappi

Head

Guarantees, Securitisation & Microfinance

EUROPEAN INVESTMENT BANK

Guido Bichisao

Director

Institutional Strategy Department

European Investment Bank Group response to:

BoE/ECB Discussion Paper – The case for a better functioning securitisation market in the European Union

	Question	Answer
1.	Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?	*Yes. We especially agree with para #36 of the ECB/BoE paper as we believe that the regulatory framework should not penalise ABS investors.*
2.	Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?	*We believe there are at least three major impediments:* *1) <u>RISK WEIGHTINGS OF ABS:</u> we believe the current regulation creates disparities among investors. Insurers and banks may be financing the same type of assets bearing the same risks, therefore it is important to gauge whether capital requirement rules under CRD-IV and Solvency II are consistent and are providing a competitive "level playing field", so as to forestall any hazardous regulatory arbitrage between the banking and the insurance sector.* *2) <u>RATINGS:</u> we strongly support the initiatives aimed at reducing mechanistic reliance on rating agencies, increasing the depth of investor due diligence and increasing information disclosure on securitisations. We are of the opinion that a sophisticated provider of credit enhancement to securitisation tranches, with rating model and information comparable to ECAIs and subject to supervisory approval, should be allowed to use its own internal credit rating in determining the capital requirement arising from externally rated and unrated guarantee exposures related to securitisation.* *3) <u>REGULATORY TREATMENT OF GUARANTEES</u>: highly rated multilateral development banks should, under normal circumstances, enable financial institutions to apply a zero risk weighting to the portion of the assets covered by their guarantees (provided the guarantees comply with risk mitigation requirements). If this cannot happen due to regulatory uncertainty, the guarantees cannot deliver at their full potential in achieving public policy objectives. To this end, we would like to promote a regulatory environment where the rules governing the eligibility of credit risk mitigation techniques are consistently and uniformly applied across Member States.*

	Question	Answer
3.	Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?	
4.	Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?	*Yes. We believe a high quality securitization standard, featuring standard structures and plain assets in the collateral pool, would lead to a more liquid market and as a consequence to a greater confidence in securitization.*

	Question	Answer
5.	The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?	*We agree with the definition, however, risks of a 'qualifying securitisation' should also be moderated, both those stemming from the assets' quality and those deriving from the structure's complexity level.* High quality *is a concept that lies with a number of factors; primarily we believe it is important that* <u>*concentration and low granularity*</u> *are correctly addressed. The following list provides an overview of what a "high quality" SME ABS could look like, according to our standpoint.* 1. ASSETS: senior, first lien, fully disbursed loans to SMEs (as defined by EU recommendation 2003/361). 2. ORIGINATOR: experienced SME lenders, not pursuing an originate-to-distribute business, keeping on their balance sheet large SME exposures. 3. BORROWERS: never marked as in insolvency in the Central Bank's register. 4. LOANS / LEASES: not in arrears by more than 60d for the past 6 months. Standard amortizing, non-syndicated, non-inflation linked. Limits on the share of loans featuring balloon payments, or switching the interest rate. Loans pay at least semi-annually. Initial portfolio WAL lower than 5 years. 5. CONCENTRATION: limits on single group/region/industry and maturity concentration. 6. STRUCTURE: Commingling and set-off considerations addressed by the structure. Cash reserve covering for both principal and interest, large enough to cover senior expenses and the debt service for 2 IPDs. Default definition within 9 months missed payments. Excess spread trapping in favour of the senior on collateral deteriorating. Plain swaps, without scheduled notional, featuring replacement languages. 7. SERVICING: no interest suspension allowed, permitted variations clearly defined in volume and magnitude, back-up provisions in place. 8. DATA: the originator receives an A1 compliance score by the European Data Warehouse, the pool is audited on an either 99/1 or 99/5 basis.
9.	Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?	

	Question	Answer
10.	These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?	*We recommend a unique framework for qualifying / high quality securitization and a limited level of delegation to national authorities, to achieve a level playing field. This would then need to be referenced in capital adequacy regulation in order to grant a preferential treatment to high quality ABS. A corresponding preferential treatment would also need to be implemented in Central Banks' refinancing policies; with the caveat that avoiding the crowding-out of the markets is of essential importance.* *We believe it would be sensible and efficient to build on the template provided in Box 3 of the ECB/BoE paper.*
11.	Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?	
12.	Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?	*On June 20, 2014, ESMA published a Regulatory Technical Standard that provides for disclosure and reporting requirements for all Structured Finance transactions in Europe. We understand that, following implementation of such regulation, ESMA will host a repository of transaction documents and investor reports comprising standardised information. We think this measure will improve the securitisation market.*

	Question	Answer
13.	Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?	*From an investor's standpoint, the originators' data provide the primary information for the assessment of the credit risk of an underlying pool. The information provided by credit registers is primarily useful to assess "originate-to-distribute" portfolios, which are however not eligible for high-quality labels. A further limitation is that very few investors have the capacity for the in-depth analysis of the information from such registers.*
14.	In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks / non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?	*We believe the loan-level data already required by the ECB comprises a thorough list of variables that help define the risk profile of a loan. ESMA, in the June 20, 2014 Regulatory Technical Standard, builds on that and provides for the disclosure of such information in all SF transactions. We think this measure will improve the securitization market.*

	Question	Answer
15.	Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?	
16.	Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?	
17.	How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?	
18.	With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?	

	Question	Answer
19.	Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?	*Our overarching comment is that key to improving the ABS market is a fair and consistent regulation for ABS investors. Currently, the treatment of securitisation from regulatory capital point of view is (a) unduly stigmatising the securitisation tool, (b) it should be harmonised across regulation (CRD IV and Solvency II) and (c) it should be comparable to that of other instruments of similar risk profile - whole loans, covered bonds and other forms of secured investments.*
20.	Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?	
21.	Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?	*Yes, they are sensible and we recommend building on those to achieve a concept of high quality securitisation that, as mentioned in #5 above, speaks to assets' quality, soundness of the structure, etc.* *We do not foresee detrimental unintended consequences.*

Investor Confidence Is Key to Successful European Securitisation Market

Special Report

Healthy Securitisation Market Beneficial: Fitch Ratings agrees with the position of the Bank of England (BoE) and ECB that the development of a healthy securitisation market could have numerous benefits, including funding diversification for financial institutions, lower costs for consumer and commercial borrowers and asset diversification for investors. Such benefits were recently described in *The Case for a Better Functioning Securitisation Market in the European Union,* published jointly by the BoE and the ECB on 29 May.

Investor Confidence Paramount: Efforts to improve the functioning of the securitisation market will not be successful without a confident investor base. Investor confidence was badly shaken by the underperformance of certain asset types during the financial crisis, with many investors reluctant to resume investing in any form of securitisation. However, additional and more granular performance information – including from rating agencies – now gives investors an improved ability to distinguish the credit quality between securitisations.

Regulatory Treatment Uncertain and Inconsistent: Investor confidence would be supported by clarity and consistency in the regulatory treatment of securitised paper. The gap between capital requirements and actual transaction performance remains wide for European securitisation, despite modest reductions in the capital charges envisaged for certain sectors in the most recent Basel III and Solvency II proposals.

More Credit Protection: Post-crisis securitisations generally benefit from increased credit enhancement, particularly in asset classes and countries where loss expectations are now higher than originally envisioned because of poor asset performance during the crisis. This shift is largely due to investor demand and rating agency criteria developments. It should support investor confidence in future loss protection and rating stability when determining whether to invest in securitisations.

Ratings Caps Not a Significant Impediment: Most of Fitch's portfolio of European securitisation issuance is from countries that can achieve 'AAAsf' ratings. 'AA+sf' ratings are possible for issuers in Spain, Italy and Ireland. Only Greece and Portugal have a rating cap below 'AAsf'. Therefore, Fitch disagrees with the BoE and ECB's suggestion that sovereign rating caps have had a material impact in constraining the market's revival. Indeed, investors are showing renewed interest in peripheral European securitisations regardless of rating caps.

Sovereign Risk Treated Consistently: Fitch's ratings are intended to reflect all credit risks relating to a debt obligation. For securitisations, this includes sovereign and counterparty credit risks. Ignoring such risks would result in ratings presenting only a 'partial' view of the credit quality of securitisations and would undermine Fitch's aim for the long-term comparability of ratings across sectors. In fact, achievable ratings on securitisations remain materially higher than for other entities in the same countries (e.g. corporates and financial institutions).

Transparency Increasing: Fitch provides securitisation investors with tools and research that increase transparency of the rating process and potential transaction performance. Investor feedback suggests that there is a preference for metrics that provide increased transparency regarding collateral performance. Portfolio Loss Metrics specifically provide insight into Fitch's expectations for asset performance and the credit protection available to securities, without taking sovereign or counterparty rating caps into consideration.

Related Research

Global Structured Finance Losses: 2000-2013 Issuance (May 2014)

Capital Requirement Proposals Diverge from Structured Finance Performance (March 2013)

Criteria for Sovereign Risk in Developed Markets for Structured Finance and Covered Bonds (April 2014)

Rating Actions in EMEA SF: Asset Performance Is Dominant Downgrade Driver (October 2013)

Portfolio Loss Metrics: Increasing Transparency of Asset Performance Expectations (September 2013)

Portfolio Loss Metrics Compare - Excel File (June 2014)

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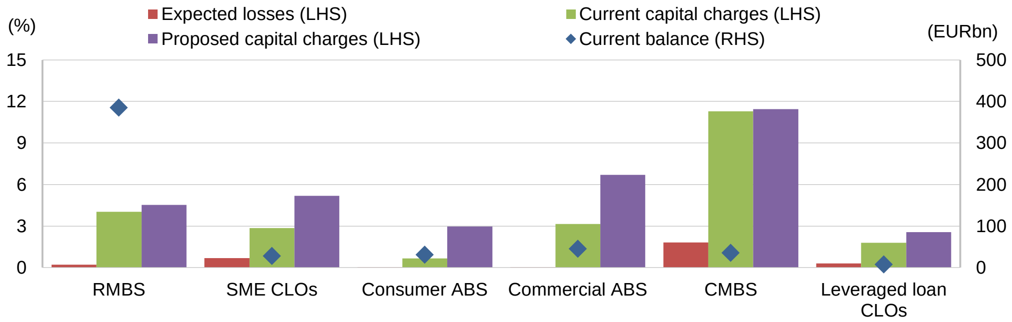
Latest Capital Charge Proposals Still Divergent From Performance

Clear and consistent regulatory treatment of securitisations is a key requirement for a large and stable investor base. The uncertainty surrounding the level of capital that different types of investors will be required to hold has itself discouraged long-term investment in these securities. Proposed capital charges continue to differ significantly from actual transaction performance for European securitisations, despite the reductions in the most recent Basel III and Solvency II proposals. In addition, in most active sectors they are more punitive than the capital charges that would apply to direct holdings in the underlying assets. If implemented, this would further discourage the key bank and insurance sectors from holding such securitisations. Consequently, this would restrict the availability of securitisation as a funding source for the real economy.

Fitch acknowledges the great challenges associated with a consistent calibration of capital requirements across asset classes, structures and jurisdictions. However, the proposed capital charges appear to have been largely driven by the worst-performing asset classes, including US RMBS, and do not correspond to the historically observed performance of currently active European securitisation markets.

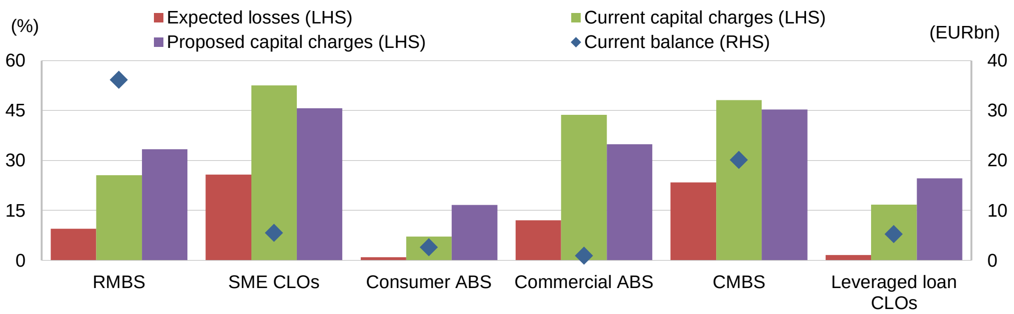
Figures 1 and 2 compare expected losses on outstanding Fitch-rated tranches in various European securitisation sectors to their current and proposed capital charges under Basel regulations. In all cases, both the current and proposed capital charges represent multiples of the expected losses on the bonds. This is true across sectors for both senior and non-senior bonds, though it is particularly marked for the former.

Figure 1
Basel Capital Charges - EU Securitisations (Senior Tranches)



Note: Passthrough structures only. Capital charges calculated with external ratings-based approach
Source: Fitch (as of 31 Dec 2013)

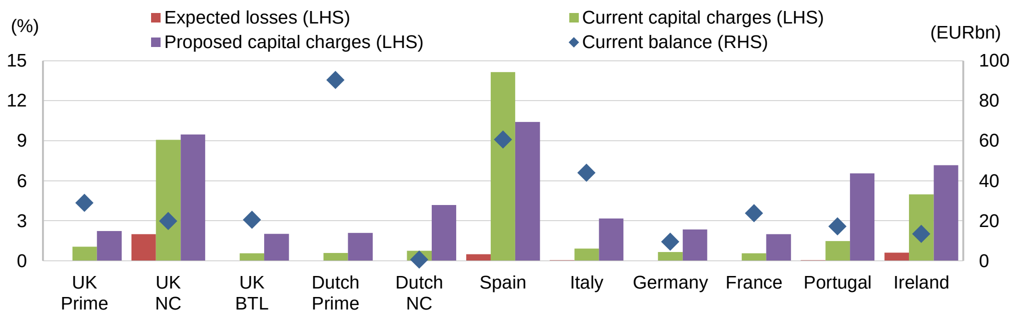
Figure 2
Basel Capital Charges - EU Securitisations (Non-Senior Tranches)



Note: Passthrough structures only. Capital charges calculated with external ratings-based approach
Source: Fitch (as of 31 Dec 2013)

Figure 3

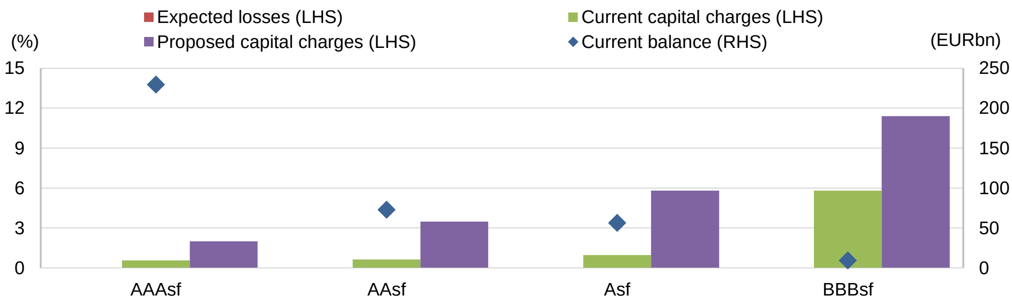
Basel Capital Charges by Country - EU RMBS (Senior Tranches)



Note: Passthrough structures only. Capital charges calculated with external ratings-based approach
Source: Fitch (as of 31 Dec 2013)

Figure 4

Basel Capital Charges by Rating - EU RMBS (Senior Tranches)



Note: Passthrough structures only. Capital charges calculated with external ratings-based approach
Source: Fitch (as of 31 Dec 2013)

The European RMBS market is broken into its main sub-sectors, as well as its senior rating categories in Figures 3 and 4. Combined with the previous graphs, they illustrate that the European asset classes and countries that have experienced the greatest volatility in historical performance (e.g. CMBS and Spanish RMBS) will see the least change in capital charges under the proposals, while sectors that have been most resilient (e.g. UK and Dutch prime RMBS and consumer ABS) will see the greatest increase in capital charges. Similarly, the increase in proposed capital charges is proportionally greater for senior, highly rated bonds. This is despite the increased credit protection that is available to senior tranches in post-crisis transactions (discussed in more detail below).

Even if the capital charges were calibrated against the performance of deals from pre-crisis vintages, this would over-estimate likely future losses as post crisis transactions benefit from more investor friendly structures such as extra credit enhancement, stricter originator underwriting and more sustainable asset market values.

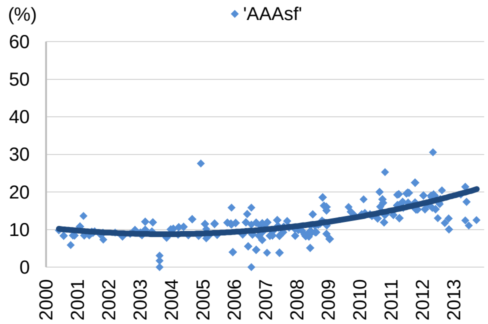
Increased Credit Protection Will Benefit Investor Confidence

The average credit enhancement available to senior tranches of securitisations has increased across the majority of sectors. However, the change has been most pronounced in asset classes and countries that materially underperformed during the crisis. This shift reflects both changes in rating criteria and assumptions, as well as investor demand. Fitch believes that such increased credit protection will support investors’ confidence in both rating stability and loss protection when determining whether to invest in the sector.

The following charts compare trends in credit enhancement on senior tranches across various sectors. In RMBS, the most pronounced increase is for Spanish transactions, which were heavily affected by the housing market decline and had large variations in performance across individual portfolios. They are followed by Italian RMBS, which were also affected by the economic downturn, albeit to a lesser extent. The overall UK economy suffered less by comparison. However, the housing market remains exposed to risks relating to overheating and a potential resurgence in arrears and repossessions when interest rates rise, due to the predominance of floating-rate mortgages. At the lower end of the spectrum is Dutch RMBS, where only a marginal deterioration in performance was observed during the crisis. In all cases, increases in credit enhancement reflect Fitch's expectations for future performance to further deteriorate before improving.

Figure 5

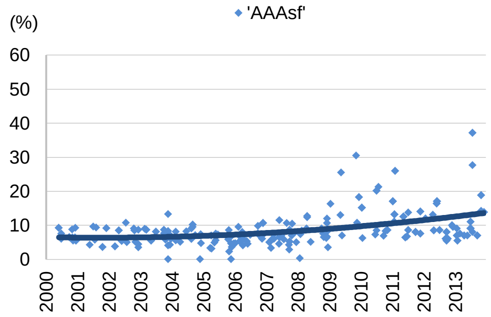
Original Credit Enhancement Senior UK Prime RMBS



Source: Fitch

Figure 6

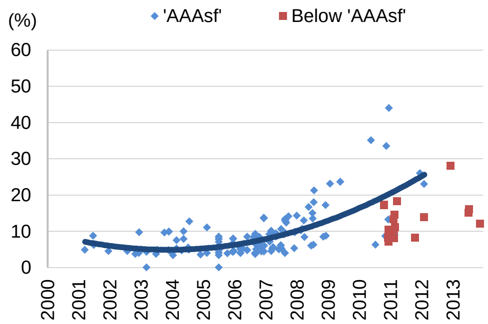
Original Credit Enhancement Senior Dutch Prime RMBS



Source: Fitch

Figure 7

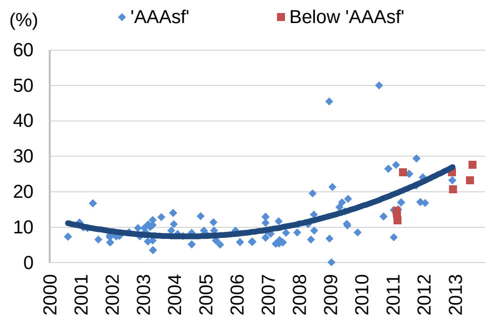
Original Credit Enhancement Senior Spanish Prime RMBS



Source: Fitch

Figure 8

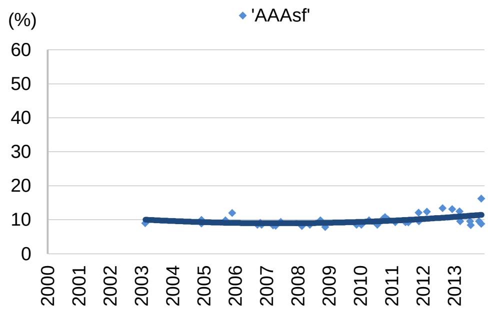
Original Credit Enhancement Senior Italian Prime RMBS



Source: Fitch

Figure 9

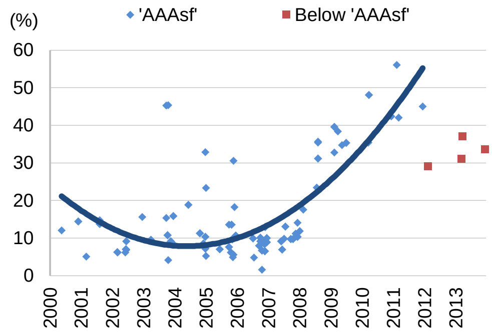
Original Credit Enhancement Senior German Auto Loan ABS



Source: Fitch

Figure 10

Original Credit Enhancement Senior Spanish SME CLOs



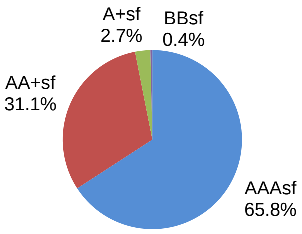
Source: Fitch

Consumer ABS performance was broadly stable and within expectations throughout the crisis, reflected in the limited change to credit enhancement for German auto loan ABS. In the SME CLO sector, the relative stability of core European transactions contrasts with the sharp increase in credit enhancement for Spanish transactions. Again, the increased credit enhancement reflects the underperformance of the sector during the crisis relative to original expectations and Fitch's expectations for further performance deterioration before stabilising.

Figure 11

Highest Achievable Ratings

% of Fitch-rated balance



Source: Fitch (as of 31 Dec 2013)

Sovereign Rating Caps not a Limitation

97% of European Securitisations can Reach 'AA+sf' or Higher

Fitch's European securitisation rating portfolio is dominated by transactions in countries with no sovereign rating caps, where tranches continue to achieve 'AAAsf' ratings. The largest proportion relates to the UK, Netherlands, Belgium, Germany and France; together with smaller contributors, these countries account for 66% of the outstanding Fitch-rated securitisation volume. An additional 31% relates to Spanish, Italian and Irish transactions, which can reach 'AA+sf' ratings. Figure 11 shows that only 3% of Fitch-rated bonds relate to Portugal and Greece, where Fitch's sovereign ceiling caps all ratings below 'AAsf'.

Figure 12

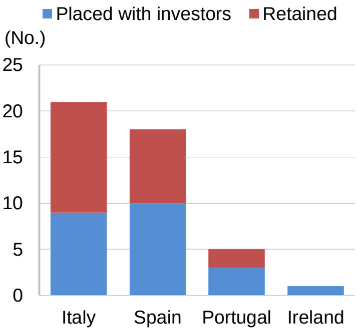
Impact of Rating Caps on European Securitisations

	Sovereign Issuer Default Rating[a]	% of Current Balance[b]	% of Tranches[b]
'AAAsf' maximum securitisation rating			
United Kingdom	AA+/Stable	30.5	39.4
Netherlands	AAA/Negative	13.0	8.0
Belgium	AA/Stable	7.9	0.7
Germany	AAA/Stable	5.9	9.3
France	AA+/Stable	5.5	2.5
Other	Varies	0.2	0.4
Multi-jurisdictional[c]	n.a.	2.9	11.2
'AA+sf' maximum securitisation rating			
Spain	BBB+/Stable	21.2	17.6
Italy	BBB+/Stable	8.1	6.7
Ireland	BBB+/Stable	1.8	1.0
'A+sf' maximum securitisation rating			
Portugal	BB+/Positive	2.7	2.4
'BBsf' maximum securitisation rating			
Greece	B/Stable	0.4	0.8

[a] As of 30 June 2014
[b] As of 31 Dec 2013
[c] Multi-jurisdictional transactions mainly include managed portfolios (e.g. leveraged loan CLOs, legacy SF CDOs) and certain CMBS transactions. For more detail on the impact of rating caps on such transactions, please refer to *Criteria for Sovereign Risk in Developed Markets for Structured Finance and Covered Bonds*, published 11 April 2014.
Source: Fitch

Figure 13

Peripheral Securitisations 2H13-1H14



Source: Fitch

Asset market underperformance – rather than sovereign cap limitations – has been the main driver of downgrades from the start of the crisis. Sovereign-related downgrades accounted for only approximately 10% of negative rating actions. The effect of the financial crisis has had a greater impact on some asset pools than the sovereign debt crisis alone. For example, Fitch's securitisation ratings in Ireland and Greece have generally been more sensitive to the change in expectations for the assets than to any overriding ratings cap.

While sovereign risk can indeed act as a cap on securitisation ratings, achievable ratings remain materially higher than for other entities in the same countries. For example, the largest Spanish and Italian banks are rated in the 'A' and 'BBB' ranges, respectively, compared to the significantly higher achievable securitisation rating of 'AA+sf' from both countries.

Despite sovereign-related rating caps, peripheral European securitisations have recently benefited from renewed investor interest. 45 such transactions were issued in the last 12 months; 23 of these were publicly placed with investors and many were oversubscribed at issue.

Sovereign Rating Caps are Appropriate and Meaningful

All of Fitch's ratings are intended to reflect all credit risks relating to a debt obligation; in the case of securitisations, this includes sovereign and counterparty credit risks. Ignoring such risks would result in ratings presenting only a 'partial' view of the credit quality of securitisations and would undermine Fitch's aim for the long-term comparability of ratings across sectors. Caps on securitisation ratings are therefore intended to ensure all risks are addressed in a meaningful, consistent and appropriate way.

Sovereign-related rating caps based on the country ceiling are applied to all Fitch ratings and are not unique to securitisations. In fact, securitisations achieve higher ratings in relation to the sovereign than any other sector. This is possible because the performance of SF transactions can be further removed from sovereign risk than that of banks or corporates; however, it does not mean that sovereign-related risks are absent from transactions.

Fitch aims for its highest ratings – especially 'AAAsf' ratings – to be stable over time and only to be downgraded under exceptional circumstances. There are two principal considerations that support sovereign-related caps as a means of achieving this goal. First, 'AAAsf' securitisation assumptions for low-rated sovereigns would be highly susceptible to volatility and would lack precedent. Secondly, a low-rated country has an inherently greater risk of exiting the eurozone and consequently redenominating its local debts. If this risk were not reflected in European securitisation ratings through the application of a rating cap, 'AAAsf' rated notes could face a sudden downgrade cliff to almost certain default if that scenario were to materialise. For both of these reasons, assigning or maintaining 'AAAsf' ratings in jurisdictions with low sovereign ratings would be inconsistent with the stated aim of long term rating stability.

It is important to note that the presence of rating caps in certain countries does not mean that there is an expectation of default for securitisations of assets in these countries. For example, if the senior notes of a securitisation with appropriate levels of credit enhancement were capped at a 'BBsf' rating due to sovereign concerns, they would not be considered distressed or expected to default. However, the relative risks faced by such notes would not be compatible with ratings up to 'AAAsf', as the proximity to default would be greater than on securitisations from more highly-rated countries. This rationale applies to Greek securitisations, which were not expected to and did not default when Greek sovereign debt was restructured.

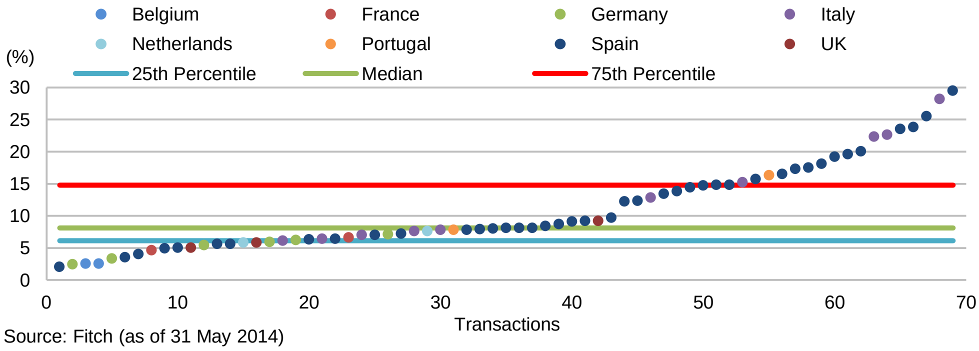
Additional Metrics More Insightful Than Implied Rating Matrix

Investor consultation carried out by Fitch has suggested that there is a preference for metrics that provide increased transparency regarding collateral performance, rather than some form of implied rating matrix that excludes or sensitises certain aspects of the rating. In particular, investors do not want additional or alternate ratings for securitisations. Consequently, Fitch launched "Portfolio Loss Metrics" to provide more information on Fitch's views on the expected performance of transactions' asset portfolios. The *Loss Metrics Compare* file, most recently published on 9 June 2014, allows investors to select individual transactions and compare their metrics against other transactions or averages across countries, vintages and/or originators.

The graphs below display Portfolio Loss Metrics for the SME CLO sector (see *SME CLOs – Portfolio Loss Metrics*, published 9 June 2014). The first chart shows Fitch's Portfolio Loss Expectations (PLE), which indicates the proportion of the outstanding principal balance of the asset portfolio that Fitch expects to be lost. This measure varies significantly across transactions, ranging from 2% to nearly 30%. The median PLE is 8.1%, with 25% of the portfolios expected to suffer a loss of less than 6.1% and 25% expected to suffer a loss over 14.8%.

Figure 14

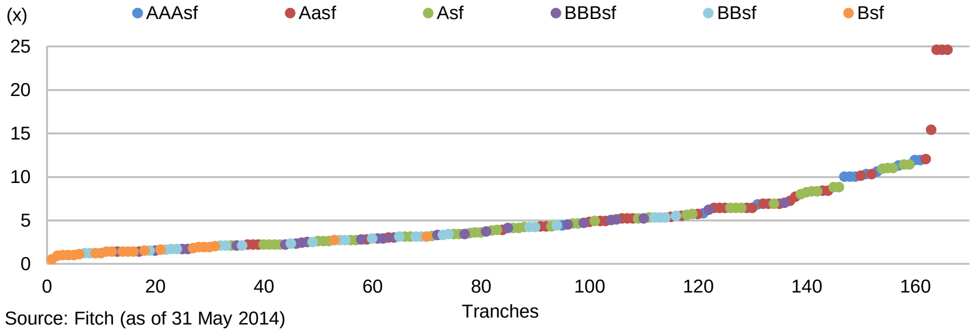
SME CLO Portfolio Loss Expectation (PLE) by Country



Source: Fitch (as of 31 May 2014)

Figure 15

SME CLO Portfolio Loss Multiple (PLM) by Rating Category



Source: Fitch (as of 31 May 2014)

The second chart shows Portfolio Loss Multiples (PLM), which represents the coverage of the PLE provided by the credit enhancement available for each tranche. The highest PLMs in the 'AAsf' rating category are from older vintage Spanish transactions that have built up substantial credit enhancement, but cannot achieve 'AAAsf' ratings due to the sovereign rating cap of 'AA+sf'. This illustrates how investors can use this additional information to identify tranches that cannot achieve 'AAAsf' ratings but that have high levels of credit support relative to Fitch's loss expectations.

Fitch's Portfolio Loss Metrics provide additional information on individual transactions and allow investors to drilldown into their asset performance. By contrast, we believe that a matrix showing implied ratings without a sovereign rating cap would be of limited value, and could indeed be misleading. The manner in which individual asset sectors react to sovereign-related risks will differ according to the degree of interdependence of the sector with sovereign risk, and the specific circumstances driving the risk (e.g. the presence of asset bubbles). Assumptions may therefore vary on a sector- and country-specific basis, which could not be meaningfully captured in a rating matrix.

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French Banking Federation Response to the ECB and BoE Discussion Paper "The case for a better functioning securitisation market in the European Union"

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The FBF welcomes the opportunity to comment on the discussion paper issued by the European Central Bank (ECB) and Bank of England (BoE) regarding the case for a better functioning securitisation market in the European Union (the "Discussion Paper").

The FBF and its members would like to thank the Central Banks for producing such an exhaustive and well-balanced paper on the role of securitisation within Europe and the impediments for the revival of the EU's securitisation market. Whilst we support the "high quality securitisation"/ "qualifying securitisation" principle, we welcome the debate on how the definition of "qualifying securitisation" (QS) should be addressed and on the certification process for QS.

I. General comments

The FBF agrees with the objectives stated in the Discussion Paper regarding the development of securitisations markets. It seems indeed useful to develop these markets to help to finance the economy, in a context in which banks are now subject to a strict regulatory framework, which is likely to prevent them increasing their balance sheet volume, constrain the level of own funds they can use to finance loans, limit the transformation they can perform and force them to dedicate increasing amounts to the constitution of a liquidity buffer.

In the opinion of the FBF, **the main issue to be treated to improve the functioning of the securitisation market in Europe is the prudential treatment of securitisation**. Incentives are currently low both for the originators and for the investors to issue or acquire ABS.

- This is especially true concerning the solvency treatment for investors. This treatment remains penalizing in the consultative document published by the Basel Committee in December 2013. A policy option that should be considered is to make the solvency treatment of securitisations more consistent with the one granted to covered bonds, which are products comparable to securitisations since they are also backed by assets originated by the bank. Currently, as a refinancing tool, securitisations suffer a lot from that comparison with covered bonds.
- This is also true concerning the liquidity treatment for investors. The FBF notes that a step is currently being undertaken in the direction of defining “qualifying securitisations” as far as liquidity is concerned, since in the Delegated Act on LCR, securitisation might be better treated than forecasted, with criteria in line with those mentioned in the Discussion Paper. Haircuts applied to ABS remain however very high, with a minimum of 25% up to 35% and a classification in level 2B considerably limiting the amount of securitisations authorized in the liquidity buffer as compared to covered bonds. It would be more consistent to apply haircuts similar to those applied by the Central Banks in the context of their refinancing operations.
- For the originator:
  - the funding (senior tranches) is expensive due to the regulatory constraints imposed to investors that drives spreads up;
  - the benefit in terms of leverage ratio and in terms of RWA is currently low when compared to the costs of issuing securitisations eligible to deconsolidation or to the notion of “significant transfer or risks” moreover the regulatory framework is not achieved, which might not provide for enough security to undertake a long and costly operation.

The FBF notes that the Discussion Paper mainly deals with securitisation done with assets originated by the concerned institution. However, there is an important part of ABS and ABCP in Europe which are done with assets directly bought from the clients by the securitisation vehicles. Such kinds of ABS and ABCP also represent an important way to finance the real economy, and therefore need to benefit from a market liquidity, and should not be forgotten when defining the “qualifying securitisations” mentioned by the Central Banks.

Other initiatives regarding the transparency of the information allowing the investors to correctly assess the risks generated by the products sold are welcome. However, the requirements should not be so detailed such that they in fact hinder the issuance of new products. For example, the requirement to publicly disclose some detailed characteristics of the portfolio loan per loan, such as the internal ratings, could cause legal issues. For example ESMA published on 24 June 2014 details of new disclosure regime for structured finance instruments (SFI) in the final draft RTS for CRA3 regulation. In this RTS, issuers are requested to publish detailed information on the underlying pool even for ABCP and private deals, which could imply additional cost for the transactions and may be an issue in terms of confidentiality with the clients.

Instead, public authorities could help the market to develop by disclosing the historical behavior of different kinds of loans, or coordinating the efforts to disclose prices and indexes. In addition, standardization of the documentation is welcome, taking into account however that some differences remain in the national securitisation frameworks.

Initiatives regarding the access to ancillary facilities are welcome, despite the fact initiatives mentioned in the Discussion Paper seem difficult to apply. This issue seems an area to be further explored and developed, as costs generated by the issuance of new securitisations are indeed a barrier to the development of the market. For example, larger EMIR exemptions for securitisation swaps could be considered.

Market liquidity will be developed when other barriers have been lifted. Especially, the current reputational problems of securitisations could be lifted if the regulators themselves recognize that they can benefit from a better prudential treatment, according to the principles to be defined. The process of "certification" will be important in that matter and more clarity would be welcomed concerning the way regulators intend to grant the "qualifying securitisation" label to a structure (granting by the National Central Banks? The supervisor? The rating agencies?).

Qualifying securitisations and policy objectives

First and foremost, we share the view expressed in the Discussion Paper that the "*use of 'qualifying securitisation' should not be regarded as a one-size-fits-all approach; additional requirements may be needed depending on the application*"[1]. In our view, the contemplated approaches/ definitions for HQS should be aligned with the two quoted potential benefits for 'qualifying' securitisations, "*improved secondary market liquidity*" and "*specific capital treatment*"[2]. Also, we agree that "*different objectives may require different market characteristics*"[3]. Consequently, the approach for defining QS is subject to prior identification of clear policy objectives for HQS.

One can assume that policy objectives may encompass the following:

1. *Reviving the EU securitisation market by supporting simple, structural robustness and transparent products,*
2. *Focusing on the economic sectors approved by policy makers,*
3. *Reducing reliance on rating agencies within the regulatory capital framework,*
4. *Increasing transparency for investors,*
5. *Increasing the secondary market liquidity.*

The French banks support all these policy objectives. We consider that the EU regulatory approach (under CRR, both capital and liquidity frameworks, and Solvency II) and the future international regulatory framework for securitisation should be more risk-sensitive aiming at correctly reflecting the characteristics of each securitisation product (credit and liquidity risks).

[1] Point 20
2 Point 20
3 Point 50

Thus, the potential uses for '*qualifying securitisation*'/ '*high quality securitisation within the qualifying securitisation category*' need to be clearly assessed and stated. In our opinion, the high quality securitisation can be used for:

a. *Capital requirements: Basel risk weight floor*

A minimally disruptive change in the Basel capital framework would be to allow a lower floor for regulatory capital, on a fixed-value basis or a risk sensitive basis (which would mainly depend on the risk sensitiveness of the underlying assets). For funding purposes, the key issue is the senior tranche which currently attracts too much capital for high quality pool assets. The same issue concerns the EU ABCP transactions (alternative and important source of funding for EU corporates, decorrelated from their credit risk) which would be highly penalised by the proposed risk floor (i.e. 15% RW).

b. *Capital requirements: Lower risk weights*

Lower risk weights would be justified by an analysis of the risk but they suppose alternative calibration and significant deviation from Basel framework (the actual framework or the under discussion RWAs' calibration at the BCBS level). The FBF supports the alternative proposal for calibrating the RWAs, the Conservative Monotone Approach proposed by the AFA Quant Group.[4]

c. *Liquidity requirements: LCR Haircuts*

Minimally disruptive change into the regulations would be to permit lower haircuts for QS.

d. *Liquidity requirements: LCR eligibility*

As contemplated by the European Commission, a broader set of asset classes could be granted LCR eligibility. Short dated real economy securitisations like auto loan ABS and ABCP justify this approach.

Qualifying securitisations and definition approach

We welcome the high level principle-based approach proposed by the ECB and BoE. We understand that such a "*designation is not intended to provide an opinion on credit or other risks, but make the assessment of these risks more straightforward. The designation would apply to all tranches of the securitisation*."[5] In addition, we welcome that this principle-based approach should serve as a building block or "*platform*" from "*which more detailed criteria could be built as appropriate (e.g. regulatory capital and liquidity treatment, credit rating assessment, etc*.)"[6]. Therefore, the "*designation*" level and the "*regulatory treatment*" level (either capital or liquidity) do not rely on the same amount of information or requirements.

[4] Please refer to the website www.riskcontrollimited.com
[5] Point 126
[6] Point 127

For the regulatory treatment level, specific and additional criteria need to be formalized, and we consider that the regulatory treatment should be appropriately differentiated across the tranches of qualifying securitisation. This appropriated regulatory regime would better reflect the level of risks associated with these positions.

Indeed, regulators could propose:

1. A **more differentiated risk-based approach** (a gradual scale would assess on the regulatory side the level of risk and the regulatory requirements), or
2. A **binary approach** where "*qualifying*" would allow for differentiating a single category of securitisation, with a unique regulatory treatment, or
3. A **combination of both**, where a securitisation transaction could be considered as "*qualifying*", while the regulatory treatment of each tranche would follow a risk-based approach (i.e. for LCR purposes, only the senior tranche of a qualifying securitisation would be eligible, the same for the risk weight floor under the capital requirements, whilst the risk weights applicable to the non-senior tranches of a qualifying securitisation would also incorporate the seniority/ credit enhancement level).

We support the combination of "qualifying" and "differentiated risk-based approach" (i.e. the third approach above): we consider that both approaches (a 'qualitative' label and a quantitative approach) will have to be combined to cover all the spectrum of operations.

Qualifying securitisations and consistency

We welcome the official positions on taking a holistic perspective on the securitisation related issues in Europe, including the high quality securitisation debate. Consistency across regulations (Solvency II versus CRR) or within a regulation for different asset classes (securitisation against covered bonds within the CRR) should be properly considered.

II. Detailed comments on some specific points of the Discussion Paper

1. Comments on the principles of a "qualifying securitization" (Box3)

The FBF welcomes the principle-based approach regarding the definition of "qualifying securitisation". The FBF would like to stress that similar approaches have already been undertaken both by the industry, with the "PCS" label ("prime collateralized securities"), and by regulators (EIOPA, the European Central Bank with the criteria for Central Bank eligibility and the EDW data repository).

Detailed comments on the principles evoked in the Discussion Paper are the following:

- Qualifying securitisations should not exclude securitisations with a revolving period that allow financing short term assets. Instead, enough transparency (e.g. on eligibility criteria) should allow investors to correctly assess the potential additional risks generated by such types of securitisation.
- Qualifying securitisations should not prohibit the seller from keeping some degree of management of the assets (including servicing, recovery management, and in some circumstances negotiating some amendments to the credit) provided such rights are clearly explained in the prospectus; especially when the originator is a bank and runs a client relationship with the debtors, such agreements can be beneficial both for the seller and the investors provided the rules are clearly set and understood.
- The qualifying securitisations standard should not require initial designation at closing of back up functions (e.g. on servicer, swap counterparty) ; they should however (i) set a clear framework for the replacement of such roles including the events triggering the replacement and (ii) define the party(ies) in charge of the appointment of new entity(ies) for such roles. This would avoid costs when no back up function is actually used, and allow a potentially better choice at the time a replacement of any servicer or counterparty is actually necessary.
- The qualifying securitisations standard should not prohibit call and remarketing clauses, provided again the framework of the remarketing is clearly set. Such mechanism allows to use securitisations to refinance long term assets at a reasonable funding cost for the seller, and allow at the same time investors to get additional remuneration in relation with the remarketing risk.

Concerning the transparency issue:

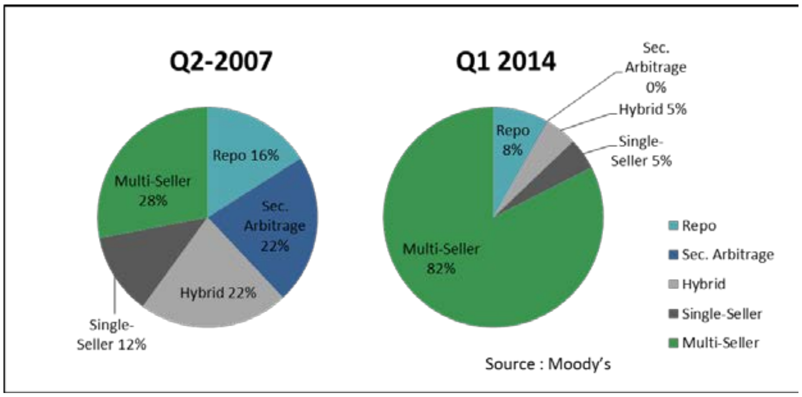
- Concerning the supplying of loan per loan information, the European Data Warehouse (EDW) should remain the reference for the euro zone for qualifying securitisations. Adding another data repository would be burdensome and redundant, since EDW is already very detailed and is used for the vast majority of the recent ECB eligible transactions. Cash flows models can however be published separately through specialized market data providers, and is a useful additional information for investors.
- The disclosure of the historical behavior of the portfolio should allow some imperfections. A gradual approach for qualifying securitisations might be implemented if all the historical data are not available (i.e. giving more benefit when historical data set are considered as more complete). This is currently the approach used by rating agencies.

2. **Why ABCP conduit transactions and CPs issued by the conduit should be identified as ‘qualifying securitisation’?**

<u>No loss for Multi-seller ABCP conduits during the crisis</u>

In the discussion paper, ABCP conduits and trade receivables transactions are not mentioned as assets that could be defined as ‘qualifying securitisation’. The few references to ABCP conduits in the document are in Box 4, where is explained what happened during the financial crisis of 2007. Indeed some ABCP investors suffered from losses during the crisis, however it was not on multi-seller ABCP conduits, but on other types of conduits such as SIVs and securities arbitrage conduits.

Today, the ABCP market comprises mainly of plain vanilla, traditional multi-seller conduits. Gone are the days when the market included more-sophisticated structures such as SIVs or securities arbitrage conduits. Although there are some securities arbitrage programs still outstanding, most of them are in the process of winding down as they let their securities run off. These are securities such as RMBS, CMBS, and CDOs, which most sponsors/investors would rather not continue to fund. Indeed, based on data published by Moody's, the global outstanding of ABCP conduits in Europe is around 77 Bn USD, 82% of the ABCP market as per Q1 2014 comprises multi-seller conduits sponsored by banks or independent companies versus 28% as per Q2 2007 — a reflection of investors' preference for this type of structure.

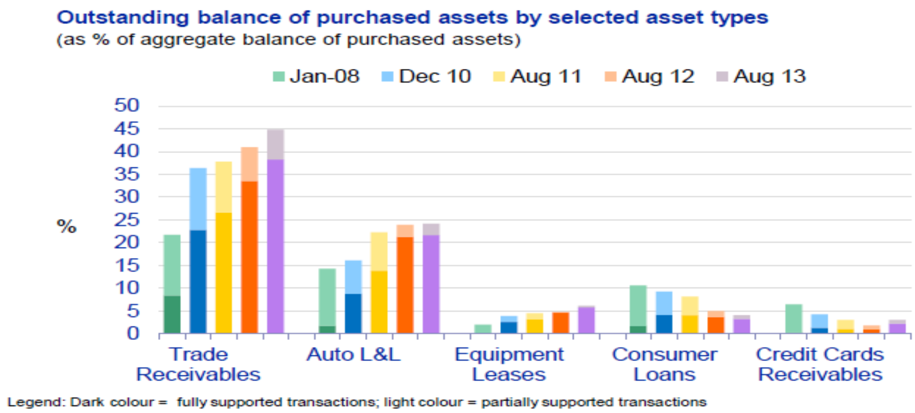


Contrary to SIVs, multi-seller ABCP conduits have weathered the crisis very well, first because they were differently structured (with bank liquidity lines covering 100% of the outstanding CPs), and second because they were (and are) financing real economy assets with direct access to the sellers, which enables asset performance transparency and favors dialogue for potential restructuring when necessary. During the subprime and the Lehman crises, multi-seller ABCP conduits did not exhibit the same illiquidity as SIVs and arbitrage programs. And at the time of the Euro sovereign debts crisis in 2011, multi-seller ABCP conduits evidenced stronger resilience. An important reason for this is that these products have had sound underwriting practices.

Conduit show a low-risk profile based on the robust structure of the securitisation financing whereby the conduits only purchase a senior tranche in each portfolio, protected by significant overcollateralization: the originators of the portfolios always retain the first-loss tranche, which is typically dynamically adjusted to the performance of the portfolio, tight cash controls, and appropriate portfolio performance covenants which allow for early wind down of the financing if the portfolio deteriorates.

Multi-seller ABCP conduits finance real economy

Multi-seller ABCP Conduits provide European corporates, and then the real economy, with a sustainable and resilient funding alternative to borrowing directly from banks. The assets funded in ABCP conduits are simple assets of good quality and short term pretty much like those we can find in factoring activity. The main part of the underlying assets, funded in multi-seller ABCP conduit in EMEA, is trade and auto receivables (72% as of Q1-2014), this share increasing continuously since 2008 compared to longer term assets (eg. CLO, consumer loans and residential mortgages) as described in the graph below.



This type of funding arrangement has proven to be compelling both for clients and for banks. Client benefits – low cost source of working capital, diversification of funding sources, allows for the warehousing of assets prior to ABS issuance, lowers company's overall cost of capital, anonymous access to the liquid short term market. For the bank it is a way of arranging market funding to major clients on the basis of well-diversified pools of receivables such that the credit profile is higher than that of the seller of the assets. It is a very efficient way of increasing the availability of funding and avoid tapping the limited market or bank appetite for the borrower's general corporate risk.

Main regulatory initiatives that are penalizing ABCP conduits

As well explained in the discussion paper, the current regulatory environment has a negative impact on the whole securitisation market because of its uncertainty, but also because it is perceived as unduly conservative. If we do a focus on ABCP conduits, the main impacting regulations are:

1- **The Liquidity Coverage Ratio** (LCR) defined in Basel III: ABCP conduits are strongly impacted by this rule since it is a short term refinancing tool and then have a good share of the outflows under 30 days. This rule has a direct impact on the price of the funding for the client, because to reduce the LCR impact at the bank level, the conduits have to fund the assets issuing longer term paper (over 1 month) which is more expensive.
2- **The new capital framework for securitisation** proposed by the Basel Committee: this rule may have an impact on regulated ABCP investors but the main impact is on the banks sponsoring ABCP conduits. In fact banks attract capital because of the liquidity lines provided to the conduits to protect the ABCP investors from underlying assets losses. The new proposal will immediately increase the price for the clients and in some cases, capital applied to ABCP conduits transactions could be higher than if the bank was lending on an unsecured basis to the same corporate. In those circumstances, it is obvious that a structure transaction would no longer make sense, and the client would borrow unsecured, increasing the final risk for the banks sector.
3- **The Money Market Fund (MMF) Reform in Europe**: securitisation positions were in the first proposal excluded from the scope of eligible assets a MMF in Europe could invest in, which was a big issue for ABCP conduits in Europe since around 70% of ABCP investors are European MMF. Thanks to explanation efforts from the banking industry, but also from some corporate clients (i.e. Auto companies), the proposal has been amended to include ABCP backed by corporate debt assets, including trade receivables but not auto and consumer loans. Further lobbying effort is currently done to increase the scope of eligible asset classes…
4-

If the MMF reform is too restrictive, the risk is to see the ABCP conduits looking for funding mainly in US because the rules are less penalizing regarding US MMF. But do we want to finance European companies in US, when we know what happened during the sovereign debt crisis of 2011?

5- The RTS published by ESMA on **CRA3** Disclosure obligations: among other requirements, private securitisation deals and ABCP issuer will have to publish all information (loan-level data, transaction structure, legal documents…) which may be an issue in terms of huge database work that this rule means (resources, costs…), but also a problem of confidentiality for banks clients. It is important to keep in mind that confidentiality is the main driver for clients to choose this kind of funding, in order not to disturb their activity (i.e. client relationship).

<u>'Qualifying securitisation' principles are in line with multi-seller ABCP conduits</u>

- Trade receivables should be included in the list of underlying assets that comply with 'qualifying securitisation' principles

Regarding Auto loans and leases, there is a consensus to say that this is an underlying asset class that may comply with the 'qualifying securitisation' principles, but trade receivables are never included in the list of 'good' asset classes, contrary to SME loans. On our point of view SME loans and trade receivables should benefit from the same treatment. In fact a corporate has two ways to obtain some funding: (i) by obtaining a loan from a bank (SME loans) or (ii) by financing trade receivables.
Moreover trade receivables transactions have additional features that make them less risky for an investor, such as short term maturity, revolving structure, assets eligibility criteria and dynamic credit enhancement.
Based on the good quality of assets underlying an ABCP conduit programme, it is important not to penalize the sponsor bank providing the liquidity line to the conduit, and then make the bank benefit from the advantages given to 'qualifying securitisations' when calculating RWA for the liquidity line supporting a transaction.
Thanks to a less penalizing treatment this useful way of financing banks clients will remain competitive for banks compared to unsecured loans.

- ABCPs should be 'qualifying securitisations'

In an ABCP conduit transaction, the issued commercial papers enable the client to get some funding from the capital market at a very attractive price, that's why ABCP should be liquid. If ABCP are outside the scope of 'qualifying securitisation', this means that ABCPs will not be attractive for investors and then banks will have to fund these transactions on their balance-sheet, increasing at the end the cost of fund for the clients.
Moreover an ABCP can be assimilated to a short term covered bond, that's why we think that the regulatory treatment of ABCP should be made more consistent with the one granted to covered bonds.
Indeed when comparing a covered bond with an ABCP both are products with double recourse on the bank (issuer for covered bonds and sponsor for ABCP) and on the underlying assets.

- Eligibility to ‘qualifying securitisations’ creates a virtuous circle

Including the securitisation transactions financed in ABCP conduits in the scope of ‘qualifying securitisations’ will reduce the level of capital for the sponsor bank, and then enable ABCP conduit financing to stay profitable for the bank compared to an unsecured loan. Then if the commercial papers are also ‘qualifying securitisations’, which means eligible as liquid asset for the purpose of LCR calculation, but also eligible to ECB repo, this will give to ABCP more attractiveness for investors, and then decrease the level of spread, which means at the end a reduction of the funding cost for the client.
As we know ABCP conduit is a good real economy funding tool, this is important to be sure that this kind of structure will not be jeopardized because of new regulations.

3. Synthetic securitisation

The FBF welcomes the paragraph 5 and agrees that credit risk transfer away from the banking sector can be beneficial.

Most credit risk transfer transactions are done under a synthetic format since Synthetic Risk Transfer is easier to implement than “true sale” structure: the assets are not transferred into an SPV and stay in the balance sheet of the bank with the following benefits:
- No transfer price issue and no cancelation of funding in place ;
- No need to notify the Borrowers or get their consent ;

Synthetic securitisation applies to a wide range of assets: large corporates, SME loans, Trade finance, shipping loans, etc.

Risk sharing transactions are an efficient de-risking tool for the originating bank. It transfers risk outside the banking system without dissemination of systemic risk outside the regulated space:
- The assets remain funded by the originating bank, and some leverage is implicitly provided to the investor by the bank ;
- The counterparty risk mentioned in paragraph 45 generally does not exist as the full nominal of the protection is often fully cash collateralised from inception ;
- Investor is himself term funded considering the nature of the risk and lack of liquidity on his investment ;
- No additional leverage should be provided by bank funding.

Risk sharing transactions are an efficient RWA/Capital management tool subject to adequate calibration of the regulatory formula used to compute RWA exposure on the retained tranches:
- It should be risk sensitive to give the right incentive to the bank ;
- Conservative multiplication factor (1+p) and RW floor could be justified by risk model, among which a possible underestimation of internal risk parameters of the pool (PD, LGD Asset correlation factor). They are less relevant and could be lower when the pool of assets is already on the balance sheet before securitisation

The cost of a transaction is commensurate to the risk transferred and depends on market conditions. For the bank, the decision to enter into a given transaction may depend on:
- Ability to free up line on concentration exposures ;
- Cost of saved RWA/Capital compared to alternative source of capital ;
- Return on capital on the opportunities for the redeployment of the saved RWA/capital ;

The “high cost protection” criteria should therefore be assessed in view of the risk transferred rather than historical remuneration conditions on the securitised assets. In addition, there is no waterfall mechanism in synthetic securitisation as the investor does not have access to the cash flows on the assets.

As a summary, “high quality” synthetic credit risk transfer securitisations should have the following characteristics:

- Simple and transparent structure ;
- Efficient risk transfer mechanism (no support to the investor, comprehensive SRT analysis) ;
- Strong alignment of interest between originator and investor (risk retention, loss sharing alignment) ;
- Cost assessment should be based on the risks of the pool not on the revenues it generates (this is a major difference with cash securitisation where the pools cash flows pay interest and principal on the various tranches) ;
- Investor should be term funded and should not leverage its investment with bank funding.

III. <u>Answers to certain questions raised in the Discussion Paper</u>

Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?

The document is not mentioning ABCP or the assets that are funded by ABCP being mainly trade receivables. Despite the fact that ABCP can be classified as ‘liquidity products’ under the bucket typology provided by ECB and BOE page 9, nor ABCP nor their underlying assets benefit from any regulatory advantages (LCR eligibility or Capital Charge under Basel Capital Framework - existing or December 2013 consultation) whereas there structure is very close from covered bonds – ABCP being protected by liquidity lines covering at least 100% of the ABCP issued, they should then receive equivalent regulatory treatments as covered bonds. Also, reference is made to SME Loans in § 43 and § 44 which are to be encouraged but nothing on trade receivables ABCP securitisation which is funding the working capital of companies and which has also to be encouraged. Since trade receivables are short term assets, it is normal to fund them by short term liabilities i.e. ABCP and not ABS. Size of ABCP market in Europe amounts to 57 Bios EUR equivalents in EMEA out of which 72% of asset funded are trade receivables, auto loans or auto leases (source Moody’s: EMEA ABCP Market Summary: Q1 2014). The liquidity of ABCP depends on regulatory treatments that they receive from regulators under LCR and capital charge.

Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?

As mentioned by ECB in its opinion on the EU proposal for a Regulation on the Money Market Funds dated May 22 2014, restrictions to invest in ABCP by Money Market Funds (MMF) need to be reevaluated:

6.3 Further, MMFs play an important role as one of the main investors in the market for short-term Securitisation assets, such as Asset Backed Commercial Papers (ABCPs). The ABCP market is important for the intermediation of short-term credit to the real economy, e.g. trade credit. The proposed regulation sets forth requirements for eligibility of securitisation assets for investment by MMFs, including requirements for the underlying pool of assets regarding type, credit and liquidity risk and maturity limit. While the ECB acknowledges that these requirements will increase the transparency of MMF investment portfolios and improve credit and liquidity risk management, it suggests evaluating the benefits of the contemplated restrictions to investment in ABCPs against their impact on the functioning and depth of the securitisation markets.

Due to the fact that SEC has not proposed such strict measures on ABCP in its draft proposal on US MMF, the position taken by European Commission on this proposed regulation, if adopted, will lead to the funding of European assets in ABCP conduits located in the US.
Given the liquidity crisis that happened in summer 2011 leading to run off of US investors from European names, this is a poor perspective for European economy.

Reference to draft EU MMF reform as potential impact on securitisation / ABCP in Box 2 – table 1 is missing.

Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?

Leverage ratio: securitized pools will be treated on balance sheet most of the time except if all the tranches are placed, which is quite rare, and even in such case, a balance guaranteed swap bearing no credit risk might still call the securitised assets back on balance sheet. Therefore the leverage ratio of the bank very often will not be reduced despite the non-recourse funding created by the ABS issuance, unless the IAS39 derecognition standard is clarified.

Performance history: while issuers certainly understand the importance of providing loan loss performance over time spans as long as possible, one has to be careful in the field of RMBS, which is the bedrock of the market, not to draft into the definition of QS/HQS unrealistic requirements such as performance data over the entire life cycle of the assets.

Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

Market liquidity is important for a well-functioning securitization market. The main entities which could provide market liquidity on this market are the banks (notably thanks to their secondary trading desks), that is why the capital and liquidity regulations on this asset class for the banks are so important for the improvement of the market. Therefore, for example, ABS and ABCP should be recognized into liquidity buffers under LCR.

The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

Defining a "qualifying securitisation" as being a "security where risk and pay-offs can be consistently and predictably understood" could be contemplated. However, for the sake of clarity we would prefer the following definition: "a quality/ qualifying securitisation (QS) is a **sustainable**, **simple** and **transparent** transaction that **tranches** a **portfolio** of **sustainable low-risk underlying assets**". In addition, a high quality/ qualifying securitisation (HQS) is a tranche of a Qualifying Securitisation that is **sufficiently senior** to be **robust**.

The regulatory regimes should mirror the policy objectives presented above; a Qualifying Securitisation should be assessed in a way that is compatible with policy objectives. At a minimum, the regulatory regime should not discourage QS/HQS, or better, the regulatory regime encourages QS/HQS (originators are encouraged to **issue** Quality Securitisations and investors to **invest** in High Quality Securitisations).

The high level principles included in Box 3 encompass principles related to *simplicity, structural robustness and transparency* of the qualifying securitisations (in accordance with point 126 of the DP). Our proposal consists in six principles for judging criteria for defining qualifying securitisations:

- Supporting the *simplicity* and *transparency* principles,

- Enhancing the structural robustness principle into *safe securitisation* principle, and

- Consider three additional principles: *regulatory governance principle*, *sustainability principle*, and *objective statistical basis principle.*

We propose a principle-based approach for defining a "qualifying" securitisation and support the use of the Conservative Monotone Approach (CMA) for assessing the target attachment point that a tranche should at least have to be 'sufficiently senior'. This proposal is consistent with the combination of "qualifying" and "differentiated risk based approach" presented above.

Six principles for judging criteria for defining qualifying securitisations

1. <u>Regulatory Governance Principle</u>

In our opinion this principle is extremely important for certifying the soundness of the qualifying securitisation and the proper application of other five principles. Thus, *the control parameters should permit regulators to achieve their objectives and exercise judgment in assigning the QS/ HQS label across types of exposure.*

There are multiple topics which should be under regulatory scrutiny, as the following:

1. Regulation of the origination of the underlying assets by regulators using/ defining QS/HQS for setting responsible lending rules ;
2. Regulatory control for risk measures used to define HQS ;
3. Regulatory control for the numerical parameters of any risk formula used in assessing HQS ;
4. Regulatory control of the certification process for QS/ HQS by regulating the **Independent gatekeepers** for the HQS label ;
5. Static (at inception) HQS label or dynamic control (with a frequent assessment of the validity of the HQS label) to be set forth by regulators.

A level of regulatory control is required for receiving capital/ liquidity recognition for QS/HQS. One could also contemplate that investors which apply IRB approaches perform the QS/HQS analysis and assessment. In the meantime, regulations should encompass all adequate provisions with regard to due diligences requirements for investors. The QS/HQS process should not create incentives or leeway for weaker due diligences requirements for investors.

This concept is similar to using external auditors to validate the accounts prepared by the company accountants.). Private labels like PCS, Rating Agencies, Central Banks, Competent External Auditors or Law Firms could be such gatekeepers.

- Rating agencies could provide an HQS label in addition to an external rating, as long as they are regulated by ESMA. However, this will lead them to admit there are different qualities of AAA (which is an obvious statement for all but for rating agencies) ;
- Private label as PCS or TSI could be used (need to be regulated) ;
- National central banks could approve post-closing an HQS label (such as approval process for ECB Eligibility – however the process would be driven by the jurisdiction of the underlying assets, not by the jurisdiction of issuance) ;
- Competent External Auditors or Law Firms could also be authorised to determine an HQS label.

2. <u>Sustainability Principle</u>

By developing a sustainability principle, we seek to formalise the notion that asset classes that are subject to **instabilities associated with market price effects should not form part of the QS category**. Moreover, both *the underlying assets* should be sustainable and *the securitisation market for such underlying assets* should be sustainable.

By definition, sustainable assets are real assets (no synthetic underlyings).

For a securitisation transaction done for funding purpose, according to definition above underlying assets that are sustainable are for example: residential loans[7] for an owner-occupier, with-recourse residential loans for a buy-to-let property, credit card, auto loan or an auto lease to purchase or lease an automobile, corporate trade receivable, infrastructure loan, aircraft or shipping loan or export finance, corporate loan whose purpose is to finance an investment.

The sustainability principle, coupled with history of low credit risk through time requirement for underlying assets (according to the safe securitisation principle) and "Responsible Lending Rules" or equivalent requirement would allow to provide a framework for identifying what types of underlying assets fit within QS/HQS framework in a consistent manner across asset classes, over time and across regulations or private initiatives such as EIOPA definitions of HQS, PCS or Central banks' eligibility criteria (which uses different lists of eligible assets and where asset classes are eliminated in a variety of ways).

For the securitisation market to be sustainable, the underlying assets should be illiquid and not marketable individually on the capital markets. The securitisation will provide the 'primary' funding source on the capital markets.

If an individual bond or ABS or tradable loan is individually marketable on the capital markets, those instruments can already get their primary funding from capital markets investors. A securitisation of such underlying instruments becomes often 'an arbitrage transaction' whose main aim is to extract margins, not to provide funding for the underlying assets. The funding provided to the underlying assets is a side effect of the transaction; it is on a 'secondary' basis. The securitisation market will stop completely the moment the margin extraction cannot occur at a profit:

- According to the sustainability principle, the securitisation market for 'CDOs of ABS' is not sustainable, as the underlying ABS are already liquid and tradable on the capital markets ;
- Balance-sheet Corporate Securitisations are sustainable, as both the underlying assets and the securitisation market are sustainable. A typical example would be SME loans.

3. Safe Securitisation Principle

According to this third principle, the *underlying assets* should be assets which have a history of low unexpected losses through time, *the structure* should be of low legal risk. In addition for HQS, *the tranche* must be sufficiently safe.

[7] I.e. mortgages and loans secured by a guarantee, cf. EBA report on EU covered bonds framework and capital treatment.

For *the underlying assets*, the regulators should exercise judgement and decide on the cut-off point in terms of low risk weight (on a pool basis) based on policy initiatives (the Standardised Risk weight values could be used). In addition, the underlying assets have to display a strong and predictable performance (this would exclude high volatility assets), and also minimal losses deviation through a period of severe financial stress (this would exclude new types of assets until they have a proven credit history).

Regarding *the structure* that should be of low legal risk, with structural safeguards which mitigate the legal risk (the collateral should be enforceable: proper legal true sale, no severe clawback or setoff risks), the counterparty risk (no close links) and address its structural robustness (meaning that there should be no market-based triggers, no waterfall where principal proceeds are used to pay interest would be allowed, and no trading activity in the underlying pool).

The senior QS should be sufficiently safe: the credit enhancement should cover the 10 largest exposures. This aspect will be developed further on the attachment point part.

4. Transparency Principle

According to this fourth principle, the underlying assets and the structure should be disclosed in a transparent manner to facilitate the risk assessment and comparisons. The 'substance over form' principle is a form of application of the transparency principle. We agree that transparency requirements reduce information asymmetries between originators and investors. This could be accomplished by loan-level data requirements and more standardised investor reports, by the information disclosed in Prospectuses or Offering Memorandum or equivalent, or by look-through to calculate risk parameters.

5. Simplicity Principle

According to this fifth principle, the nature of repayment risks for the underlying assets should be simple, and the structure should be designed in a simple manner.

First, with regard to the structure; we consider simplicity means that tranching is *Plain-Vanilla.* Also simplicity is not an issue of number of tranches but is an issue of non-complexity. The non-complexity means the priority of payment of the tranches is sequential or pro-rata, that is not incorporating provisions for principal proceeds diversion to pay interest if it leads to a credit enhancement erosion, etc.

Secondly, with regard to the underlying assets, only homogeneous pool should be considered (consisting of one type of asset), with no direct market risk, in the underlying assets (no LTV-based default triggers, etc…) or in the pool (no buckets valued at market).

6. Objective Statistical Basis Principle

According to this sixth principle, any risk measure used in an HQS definition (e.g. a rating or a formula-based risk measure) should be based on a clear, objective statistical measure of risk.

This principle implies that the choice of the risk measure needs to be aligned with the regulatory objectives. The external ratings (based either on Probability of Default (PD) or on Expected Loss (EL) of the tranche), which are not regulatory parameters, are poor-proxy for a HQS label. In addition, they are not stable risk measures. The Unexpected Loss (UL) is a regulatory measure, expressed as a risk weight and provides a stable risk measure for securitisation tranches (the Conservative Monotone Approach is UL-based). Therefore, regulators will be entitled to define the values of the regulatory parameters to use (eg. $CSSF_M$, ${\rho^*}_M$) to enable users to assess if an HQS tranche is sufficiently senior (this point is detailed hereunder).

<u>Using the Conservative Monotone Approach for HQS</u>

As indicated above, we propose a complementary approach for the principle-based approach for defining a “qualifying” securitisation the use of the Conservative Monotone Approach (CMA) for assessing the target attachment point that a tranche should at least have to be ‘sufficiently senior’. The CMA and the principle-based approach for definition defining a “qualifying” securitisation are complementary in supplying a substitute for agency ratings in some regulatory applications. Agencies ratings embody both quantitative analysis of the degree of conservatism in the tranching of the deal given the nature of risks in the underlying securities and qualitative analysis of the deal. Correspondingly, the CMA and the HQS principle-based approach would cover, respectively, quantitative and qualitative aspects of HQS evaluation. In addition, the CMA provides a measure of (UL+EL) rather than EL which is what ratings aim to identify (at least Moody’s style ratings, S&P/Fitch ratings focus on PD).

Based on the CMA, the formula below gives the target attachment point A_{Target} that a tranche should at least have to be ‘sufficiently senior’

$$A_{Target} = W \times K_W + LGD \times \mathrm{N}\left(\frac{\mathrm{N}^{-1}\left(\frac{K_P}{LGD} \times CSSF_M\right) - \mathrm{N}^{-1}\left(K_{Target}\right) \times \sqrt{{\rho^*}_M}}{\sqrt{1 - {\rho^*}_M}}\right)$$

The formula does not rely on ratings. It requires regulatory control, with the parameter $CSSF_M$ (capital surcharge scaling factor) and ${\rho^*}_M$ (conditional pool correlation). In Europe, regulatory control could be exercised in the different jurisdictions by the national central banks who are best equipped to assess the risks of their national assets (eg. Banque de France for French mortgages, Banco de España for Spanish SMEs…). A central supervisory process (European Central Bank or European Banking Authority) would then validate the proposed numerical values $CSSF_M$ and ${\rho^*}_M$.

Other:
References to trade receivables is missing in § 134
References to revolving securitisation is missing in Box 3

Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?

Yes.

These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?

A positive regulatory qualification of securitisation issues placed in the market could give strong support to the re-emergence of a healthy European market. The principles listed in Box 3 are generally sound in our view for securitisations placed with investors. The qualification would complement investors' own analysis of structures that they did not arrange and with which they are necessarily less familiar than the arranger. This sort of qualification would probably be most useful in all regulatory uses designed to apply mainly to assets purchased in the market: solvency rules for insurers or other investors, High Quality Liquid Asset rules for banks, etc…

We also fully agree with the statement in paragraph 102 that a "one-size-fits-all" approach for qualification rules would not be appropriate. Each regulation should appropriately calibrate the rules applying to "qualified securitisations". As far as solvency rules for banks are concerned, we would like to underline that a strict reading of Box 3 principles would not necessarily always make sense.

For example, the self-liquidating principle for securitisations placed in the market should not prevent banks from funding clients' portfolios of receivables or loans through ABCP issued by multi-seller securitisation conduits. The liquidity risks generated by these vehicles are addressed by other prudential regulations applying to banks.

Banks may also use "derivatives-based" or "synthetic" structures to transfer a significant portion of their credit risk on certain portfolios to third-party investors. The residual "securitisation positions" kept by banks should not be excluded from the qualification simply because of the use of these techniques, which are often more flexible and less costly.

In both cases, it would still be possible to perform a qualification analysis of the securitisation position held by the banks (quality of the credit risk transferred to the conduit or of the residual senior position kept by the bank).

More generally, we feel that securitisation positions held by the arrangers themselves do not require the same protections that are necessary for third-party investors, as their risk can be also addressed by more detailed regulatory formulas based on a detailed analysis of the portfolios.

The authorities could look what is done for the covered bonds market and do the same for ABS and ABCP.

[Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?

We have no comments.

Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?

We have no comments.

Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?

We have no comments.

In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

In the context of ABCP specifically, conduits prepare detailed monthly reports on the performance of each of their portfolios with information received from each client/seller and they are made available to all their CP investors. CP Investors are on record saying that they are satisfied with the types of reports they are currently receiving. It is important to understand that such information is aggregated by portfolio, and not provided on a loan level basis.

In addition to privacy laws, bank sponsors are bound by most originators and sellers of the securitized assets purchased by its conduits not to disclose confidential information about the originators' assets or customers or even the originators' name or the fact that they entered into the transaction. Such information would be commercially sensitive for these originators and the application of public disclosure requirements would likely result in the removal of this efficient source of funding for many of these originators.

Lastly, on a more practical level, the number of obligors in portfolios purchased by a conduit can reach millions. Also, trade receivables' portfolios, which are core asset classes in Europe, rotate quite quickly (days rather than months or years), with the names of the obligors and amounts owed by each rapidly changing. Providing detailed or loan-level information would be extremely cumbersome, or even impossible (not only from a practical manner but also because this information is often not available from sellers), and mostly useless.

Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?
We have no comments.

Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

We have no comments.

How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

We have no comments.

With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?

We have no comments.

Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

We have no comments.

Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?

We have no comments.

Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?

In addition to the section 2.1, it needs to be clearly stated that revolving transactions are eligible.

To whom it may concern:

Thank you for the comprehensive review of the economic benefits and barriers to more robust securitization markets in Europe. In addition to the barriers listed I would add several important fundamental legal impediments.

The structure of Civil Law liability requires much more comprehensive review in each continental EU country. Unlike Common Law jurisdictions such as the United Kingdom or the United States the right for any investor in a securitization to seize underlying collateral in a bankruptcy or other legal proceeding cannot be assumed. According to my understanding, certain investors have superior legal rights than others in credit transactions. For example, an individual who buys an asset backed security in the United States acquires all of the same rights as a bank, insurance company or other institutional investor. In Europe, the law often makes a distinction between authorized credit institutions and other investors. This necessarily limits the pool of potential investors.

My understanding is also that even if an investor can obtain full legal rights to underlying collateral in a credit transaction, the ability to transfer those rights in a secondary sale cannot always be assumed without explicit authorization in law. In other words, a bank can extend a loan and foreclose if necessary upon default, but the same cannot always be assumed if the loan is sold to a non-bank investor. For securitization to ultimately work there must be a wide variety of non-bank potential buyers with robust legal rights to underlying collateral in the event of default or liquidation.

The law essentially limits the pool of potential investors to institutional investors with legal authority to participate in credit transactions, rather than any potential investor with any legal standing in a credit relationship. Not only does this inhibit individual investor participation in the securitization marketplace, but - more importantly - it inhibits the formation of a rich ecosystem of nonbank financial institutions capable of raising and deploying capital in a much more liquid asset backed securities marketplace.

Transferring risk among existing banks and a narrow range of other approved institutions such as insurance companies through securitization will lead to a very modest marketplace. Allowing much wider diversification outside of existing credit channels will better achieve the ECB's goals and enhance the flexibility of the European financial system. In order to do this, however, the fundamental concepts embedded in laws related to liability, credit transactions, access to collateral in foreclosure and the secondary transfer of initial creditor rights must be thoroughly analyzed in each Civil Law jurisdiction within the EU or at least within the Eurozone. I did not see a discussion of these concepts in your otherwise excellent report.

Thank you once again for shining a brighter light on this important issue for the future of European economic growth and stability.

Sincerely,

Brian Friedman
President
GHP Investment Advisors, Inc.
www.ghpia.com

Comments on “The case for a better functioning securitisation market in the European Union”

Gordian Knot

4th July 2014

The Bank of England and ECB issued a joint paper titled “The case for a better functioning securitisation market in the European Union” on 29th May 2014, with requests for comments to be submitted by 4th July 2014. This memo is Gordian’s commentary on the joint paper.

Contents

Comments: Overview

The comments made here are from the perspective of both funded non-bank and bank investors, and are primarily focussed on the senior tranches of securitisations.

We have read the "request for details comments" section of the joint paper (para 147) and have provided answers to some of the 18 questions posed in Appendix 1 at the end of this paper.

We welcome the support from the Bank of England and ECB for the securitisation market. Their combined comments are important and valuable in helping to re-start this important market and make it function better for the benefit of banks, borrowers, central banks regulators and the economy. Securitisation has many benefits and there is much that we agree on:

- Securitisation is an important tool for banks, providing a substitute for both capital and term debt, and liquefying banks' balance sheets,
- Securitisation allows banks to have a more diversified funding base and reduces reliance on covered bonds, unsecured deposits, and on central bank financing, such as LTRO,
- Securitisation provides indirect access to the capital markets for all borrowers via their banks, increasing the availability of credit and reducing their cost of funds,
- Securitisation brings new sources of investor capital into the market allowing banks to sell loan portfolios, freeing up capital to support new lending,
- Securitisation provides investors with significant freedom of choice in both low risk and high risk credit products, and
- The securitisation market is operating at well below capacity as a result of the combination of media commentary ("toxic sludge") and overzealous regulation (BCBS capital risk weightings, Solvency II etc) since the financial crisis which has resulted in many investors being scared away from the asset class or finding it uneconomic.

While we agree on many issues, there are some issues on which we differ and some areas that we consider require further study. Our biggest concerns are that the process of layering on additional regulatory requirements may simply make securitisation uneconomic vs. raising capital and debt and that the costs of complying with continuous regulatory change could make participation in the securitisation market, for both issuers and investors, too high to justify.

We address our concerns towards the following five main points and expand on them in more detail further below:

1. **Senior tranches** are the largest part of most securitisations, typically being 60%-90% of the total; they offer low risk and only offer a modest return. As a consequence of the low return senior tranches require funding for most investors to be able to own them effectively.

Many investors fund these assets on a repo basis with repo funding provided by banks. We argue that this is an unstable way to hold these assets as it accelerates mark to market price volatility, aggravates interconnectedness and can exaggerate contagion risk. As banks are the largest providers of repo funding it also creates balance sheet inflation and exposes them to tail risk.

Credit and surveillance work is non-trivial, even for senior tranches, and so are the systems required to transact and manage these portfolios. Economies of scale as an investor are therefore needed to justify holding securitisations as an asset class.

Many of these assets either need hedging and/or are prepaying, requiring integrated operations, risk management and treasury functions. These requirements do not always suit unlevered, long-only, fixed rate investors, such as smaller insurance companies and pension funds who may therefore chose to delegate management to an outsourced specialist asset manager.

2. The implicit working assumption throughout the joint paper seems to be that **all tranches of a securitisation must be held by long term, real money investors**, such as insurance companies and pension funds. We observe that pre-crisis neither of these investors were the dominant investors in senior tranches (banks and bank sponsored investors were the largest investors) as they are rarely the optimal place to own all tranches of securitisations. These investors are certainly important but they are not the dominant investor class.

Further there seems to be a core belief throughout the paper that banks should not hold each other's securitisations and that only by selling every tranche of securitisations to non-banks can risk be reduced for the banking system.

Banks have an important role as market makers and, as part of a diversified investor base, as investors in the senior tranches of securitisations (rarely the junior tranches). Further that the risk to the financial system is minimised if banks are not penalised when invest in senior tranches, (i.e. on a hold to maturity and "capital equivalent" basis), as they are an important investor class when combined with many other types of investors.

3. **Standardisation of ABS structures** does not encourage investors to analyse credit risk fully and distorts the market by ensuring that all issuance is structured to "just comply" with the current standard.

Standardisation maximises the likelihood that entire sectors will experience the risk of non compliance at the same time, creating cliff effects which are likely to result in significant price volatility.

A continuum of structures and risk types is preferred as this creates a more dynamic and flexible market that is more likely to reflect the changing needs of both issuers and investors of all types.

Substituting a government backed standard for a rating agency standard both exposes taxpayers and fails to clearly place responsibility back with investors. However, standardising reporting conventions for delinquencies and defaults, setting minimum deal reporting and supporting public infrastructure for deal documentation and reports is helpful.

4. **Retention rules for originators** are poorly designed, giving banks so much freedom of choice that they are effectively encouraged to "game the system" and do not align the interest of issuers with investors.

Simple vertical retention, with the vertical percentage determined by all investors, resolves these perverse incentives and ensures alignment of the originator with investors in all tranches of the securitisation.

Non-bank loan originators should have the same vertical retention requirements. But secondary transactions, in which loans where an originator already has retained a vertical percentage are bought in the markets, should not be required to make a further retention.

5. **Regulatory capital and liquidity treatment of bank holdings of securitisations vs. other asset types:**

a. Regulatory capital requirements for securitisations are expected to follow the revised BCBS' proposals dated December 2013 which use mathematical models that are not related to the underlying loan portfolio for either the BIS III (standardised) capital requirements or to their historical loss experience. These models are not "capital equivalent" but require significantly more capital for banks holding a portfolio of loans in a securitisation than for the same underlying portfolio as whole loans.

This creates an incentive to move securitised assets, but not loans, out of the banking system it is effectively a "capital tax" on holding loan assets in securitised form for banks. This makes securitisations more expensive for banks to issue and so increases costs to end borrowers.

The BIS capital requirements also tend to guide the capital requirements for insurance companies. Consequently, in Solvency II, insurers also have high capital costs of holding securitisations.

b. Liquidity requirements in the Liquidity Coverage Ratio ("LCR") & Net Stable Funding Ration ("NSFR") are not related to either the haircuts or cost of funds in central bank facilities. These tests are also poorly specified as they are based on broad categorisations, a limited number of "time buckets" and simple behaviouralisation assumptions.

c. Covered bonds and loans both receive favourable treatment in terms of both capital and liquidity compliance vs. securitisations. This is inconsistent with both actual credit risk and market liquidity and has the perverse effect of encouraging banks to hold more risky and less liquid assets.

We fully recognise that the joint paper shares these concerns but concluded that these issues need to be critiqued fully in this public forum.

1. Senior Tranches

Senior tranches are the biggest part of securitisation, typically being 60%-90% of the total and so the economics of placing these senior tranche typically dominates an originator's decision to securitize or not.

Pricing of the senior tranche has the most important effect on the price of the overall securitisation, simply because it typically represents such a large part of the whole. A one basis point change in the cost of a junior, mezzanine or equity tranche of 5% of the total has only 1/20th of a basis point effect on the breakeven cost of the loan portfolio. Where as a 1 basis point change in the senior tranche has an almost one for one effect on the cost of the underlying loans. The cost of securitising drives the return at which banks can originate new loans (as a substitute for the return on capital and term debt) and so the return on the senior tranche is crucial in setting the costs to end borrowers.

Due to the low return and capital preservation nature of many of these senior tranches they **require funding** for most investors to be able to hold them at an acceptable return or risk adjusted capital. Access to funding and the state of the funding markets therefore is a key input to the health and level of activity in securitisation markets. Funding is either secured, collateralised by the asset usually in the form of repo, or a borrower may be able to fund unsecured.

Since the 2007-8 crisis investors are no longer willing to provide funding to non-banks unless they are collateralised in the form of a repo.

Repos are **market based funding** that require both high quality collateral and a haircut (effectively the borrower's capital) to protect the lender. As the assets are traded securities, any change in mark to market will result in additional collateral being called for by the lender. Even a small change in prices triggers a "collateral call" by lenders. This process can trigger a vicious spiral of declining prices, higher haircuts, close outs and forced liquidations, resulting in instability, especially if many entities holding similar assets are funded in the same way. Banks providing this repo financing inevitably have larger balance sheets and are exposed to the tail risk should close outs be required. So banks retain these risks, even if the system appears to have sold off the loan risk by securitising.

The **credit and surveillance** work is non-trivial as are the systems required to book and manage these portfolios. Economies of scale as an investor are needed to justify including securitisation as an asset class due to the amount of credit expertise required to perform the analysis both prior to issuance and ongoing throughout the life of each securitisation. Our view is that investing in the specialised expertise and systems to manage securitisations is non-trivial and this is the case as much for the high credit risk, high return junior tranches as much as it is for the lower risk, but larger volume senior tranches.

Many of these assets are **floating rate, need hedging** or are **prepaying** requiring integrated operations, risk management and treasury functions. These requirements do not suit unfunded, long-only, largely passive asset managers; a group that includes some insurance companies and pension funds, in particular smaller regional entities. It is not surprising that these investors tend to use specialists to manage this asset class on their behalf.

Typical **maturities** of senior tranches are 3 to 7 years, not the 10 to 20 year maturities needed to match the liability profile of life insurance and pension funds, although revolving pools can be used to generate longer term assets (para 82).

With the absence of senior investors, **central banks** have stepped into this role providing term funding by financing "retained to repo" securitisations direct to issuing banks. While this provides long term funding to banks it is not a long term solution and central banks need a private sector solution to be able to exit.

2. Investors in senior tranches

The implicit working assumption throughout the joint paper seems to be that as much of securitisations as possible and the majority of senior tranches of securitisations must be sold to non-banks. Ideally pension funds and insurance companies will bring new sources of uncorrelated capital into the banking system, so risk will be effectively transferred and this is required for the securitisation market to be capable of functioning properly. We consider this to be only part of the solution for 5 reasons:

a) **Sales to banks or to non-banks?** Clearly if the entire securitisation is sold to non-banks, and if no parts of the securitisation were funded by leveraging with banks, the risk has been exported from the banking system. The originating bank has achieved risk transfer by selling its securitisation (net of retention – ideally a vertical slice is retained – see below) and has liberated both capital and funding. But if other banks buy a senior tranche, either for trading or as a hold to maturity investment, they deploy both capital and funding to hold that senior tranche. The question is "Does the banking system in aggregate have more capital and term funding, with the senior tranche of the securitisation sold to other banks than if it the originator simply holds the loans?" Since most of the credit risk is in the high return, junior tranches, when these are sold to non-banks significant capital is brought into the banking system. See Appendix 2 for a worked example under the current BCBS proposal and under strict capital equivalence (which is very pure and hence instructive).

b) **Floating rate assets**. The Paper makes the accurate observation (para 94) that a large proportion of securitisations were floating rate. Yet, the underlying assumption is that these assets should be sold to insurance companies and pension funds.
We looked back at senior AAA tranches in European and US ABS and found than 89% of European and 73% of US tranches were floating rate. For senior AAA tranches of European RMBS 98% were floating rate. (Source Dealogic 2000-2014). This indicates that insurance companies and pension funds were not the main target investors for these assets as they generally have long term fixed rate liabilities and so prefer fixed rate assets.
We also looked at distribution statistics to get a sense of where the bonds were being sold pre-crisis and since the crisis. Insurance companies aggregated 4.8% of distribution in 2004-7 and this has increased to 11.1% 2008-present but this is based on a decrease in issuance volume to approx. 50% of pre-crisis volumes (Source AFME).

c) The **largest investors** in pre-2008 in European new issue securitisations (Source AFME 2004-2007 new issue securitisations by issuer) were **funded investors** representing **54.1%** of total investment in new issues. This was in the form of banks 35.3% and non-banks, such as, building societies, 2.4%, structured investors such as ABCP "conduits" and SIVs, 10.3%, and hedge funds, 6%. Over the same period insurance companies and pension funds invested 4.8% and 1.6% respectively. Asset managers invested in 36.8%. The asset allocation of listed European Insurers shows an allocation of 7.1% to securitisations in 2007 declining to 6.1% by 2009 and 6.0% by 2011. Today central banks represent the largest holders of senior tranches as funders of "retained to repo" transactions at 57.8% of 2013 issuance (Source AFME) having largely replaced the non-bank entities which investors will no longer fund post-crisis.

d) **Prepayment risk**. Many securitisations have prepayment risk based on the rate that underlying loans are repaid and/or refinanced (para 79). Prepayment risk adds interest rate optionality to fixed rate bonds, such as US mortgage back bonds. Prepayment risk can be more effectively managed in a floating rate note if prepayments of principal occur only on coupon reset dates. This is another reason why securitisations suit floating rate issuance and is suited to floating rate funded investors, such as banks and funded non-banks.

e) We consider the concept (para 50) of **"Liquidity products"** and **"Credit products"** a useful simplification. Senior tranches (which represent de-levered, or credit enhanced loan pools) are lower risk and higher quality than the underlying loan portfolio, and these are clearly "liquidity products". However, if all of these "liquidity products" are held outside the banking system they will be less liquid since they will not be actively traded by banks. Junior tranches (which represent re-levered or subordinated positions vs. the original loan pools) are clearly "credit products". We would go further and suggest that these are largely "Funding products" and "Capital products" since the senior tranches require significant funding capacity, while the junior tranches need to be funded with significant capital over a long term horizon.

f) **Role of banks**. Banks are important investors in securitisations as market makers, providing liquidity to markets, and also for diversifying their own risk. Most forms of structured issuer (most were set up by banks) are either no longer permitted or markets participants are no longer willing to provide funding for any leveraged entity that is not backstopped by access to central bank emergency liquidity. However, the leverage ratio makes investing in high quality, last loss assets uneconomic and perversely creates the incentive for banks to invest in more risky assets. We would expect the demand by banks for covered bonds to be affected as the leverage ratio is introduced.

   New banks, without any legacy risks, that focus on investing in senior tranches of securitisations would seem to be a good way to keep this low risk activity within the regulated space and, for investor comfort, supported by access to emergency funding. From a financial stability perspective this appears to be preferable to permitting leverage to build up outside the banking sector with repo based funding, provided by banks, and the inevitable instability that would result.

3. Standardisation

Standardisation of ABS structures affects the credit quality of each deal, the behaviour of each of investors, structurers, issuers, markets and both regulators and central banks. The place for setting standards is discussed at the end of this section.

a) **Credit quality**. While it may be reassuring to suggest that credit risk can be reduced to a simple two-state system, of complying with standards or non-complaint, credit risk exists as a continuous range. For securitisations this continuum of credit risk is based on issuer, vintage, amount and type of credit enhancement, legal structure, transparency, geography and maturity. Credit quality of each tranche of every securitisation also varies based on how the underlying loan collateral (and all other parts of the securitisation) performs during the economic cycle. This is largely based on the demographics and employment history of the underlying borrowers and how these interplay with the structure of the securitisation.

There is nothing "standard" about the credit quality of securitisation tranches, in much the same way that each underlying loan is unique.

b) **Investors** have less incentive to invest in and develop the expertise to analyse credit risk fully and are more likely to rely on a public standard that purports to measure and ensure credit quality. This is a mistake for all credit sensitive investments, which as pointed out above are unique, and it typically results in investors abrogating their responsibility to their clients. Any "standard" creates a discontinuity in the perception of risk (and return) so the only credit analysis required is how far from the standard is each bond. Every time a bond gets close to hitting the standard rational investors will try to sell first and this guarantees price volatility.

   The experience of the behaviour of "AAA" investors pre-crisis is a good example of the adherence to a de-facto market standard; with the predictable result that rating agencies were blamed for over rating, when investors, who were not paying for the ratings, should have been doing proper credit analysis themselves. Why regulators and central banks would willingly step into the heavily criticised role of the rating agencies as "standard setters" is difficult to fathom and could be an issue during the next crisis. A rating or a standard is no more than an "informed opinion" so it is difficult to see the benefit of such an involvement given the consequent risk to national regulators reputation, to central bank balance sheets and ultimately to taxpayers. The process by which low quality assets (such as US Subprime) were "transformed from junk into gold" was fully transparent to anyone who cared to question the assumptions used by the rating agencies.

c) **Structurers** have no benefit from creating better deals for investors or for any form of differentiation. This absence of a desire to be creative may fill regulators with confidence that the deals will all perform as expected. This is wrong as structurers will instead focus their skills on finding the most efficient way to "just comply" with the new regulatory standard. This results in all deals becoming "cuspy" (i.e. barely complying with the standard at issuance) and therefore more likely to fail to comply with the standard during the life of the deal. The only measure that investors will then care about is the amount of cushion they have above the standard.

d) **Issuers** have no incentive to build their own issuance franchise with investors since what they offer investors will only comply with the standard. With standardised issuance there is no benefit to issuers of exceeding the required standard. Instead issuers are incentivised only to comply with the current standard in the most cost effective way and to negotiate the standard down to the lowest level with the standard setting body. The standard setter therefore is at permanent risk of "regulatory capture". Under a system with no standards each deal must stand on its own merits. Issuers have an incentive to reach for the highest standard and to support this as this differentiation will allow them to achieve the lowest cost of funding through time.

e) **Markets**: Standardisation maximises the likelihood that entire sectors will experience pressure against complying with the standard at the same time. This creates cliff effects which ensure maximum price volatility whenever any deal fails to comply. This is because the group of investors who are permitted to hold standard compliant assets will have to sell to a different group of investors willing to hold non-compliant assets at a lower price level. The process of transitioning ownership of a single asset, or a group of related assets, from one investor base to another is likely to result in significant price volatility. Price volatility is minimised if a wide range of differing assets types, representing a continuum of credit quality, are issued to many diverse investors who are engaged in analysing and holding these assets and whose views and risk appetites will change through time.

f) **Regulators and central banks** serve the market far better by ensuring a minimum standard of disclosure and encouraging issuers to provide additional information to investors on a timely basis. Far better to provide the information for investors to do their own analysis and for central banks to communicate their risk tolerance by varying the haircuts that they will charge when collateral is placed with them based upon market conditions in real time.

   Standards should change through time as markets and issuance evolves. Having fixed standards results in erratic market shifts each time the standard is updated. A constant updating of credit quality by a diverse group of market participants is the preferred means of achieving this as it places responsibility and accountability on the market participants; investors, structurers and issuers and not on the standard setters. Our preference is that the haircuts and cost of funds used by central banks for a broad range of assets to access their emergency facilities is updated regularly, that central banks are engaged in these markets on a small scale continuously and this becomes only one aspect of the decision making process used by bank and non-bank investors.

4. Retention Rules

Retention rules for originating banks seem designed to encourage them to game the system and do not result in alignment of interest with investors.

Under current retention rules in the EU originators can choose between 5 different types of retention, each of which is set at a random retention percentage of 5%. Retention rules are subtly different for US securitisations and this inconsistency has the potential to reduce flows as pointed out in para 74.

Retention methods

a) Pro-rata retention in each of the tranches sold or transferred to investors
b) Retention of the originator’s interest for revolving exposures
c) Retention of randomly selected exposures
d) Retention of the first loss tranche
e) Retention of a first loss in every securitised exposure

For options (a) and (d) retention is 5% of the nominal value of the tranches sold or transferred, but for options (b), (c) and (e) this is 5% of the nominal value of each of the securitised exposures.

Our concern is that any issuer has significant freedom to allocate cash flows between tranches and if they are going to retain an overweight portion of a particular tranche they have a significant incentive to divert cash towards the tranche that they expect to own. This creates an asymmetric investment position vs. investors so economic interests are not aligned. Only options (a) & (c) out of the current approved methods of retention avoids this problem.

In contrast, simple vertical retention, option (a), resolves all of these conflicts and also ensures symmetrical capital treatment of the retained holdings with the underlying loans.

The vertical retention percentage can be negotiated between the originator and investors in each tranche at syndication, in much the same way that pricing is negotiated. We propose that the only regulatory requirement should be for a common retention percentage that is the same across all tranches (otherwise it wouldn't be vertical retention) and that this percentage is made public. Both pricing and retention can be varied during syndication until retention is the same across all trances and pricing is agreed for all investors and the issuer.

Non-bank loan originators should be subject to the same vertical retention requirements as otherwise they would face a competitive advantage when compared to bank originators. As the vertical percentage is negotiated with all investors at syndication all issuers have an incentive to develop a franchise with investors to achieve lower retention requirements over time.

Secondary transactions, in which loans are bought in the markets, where an originator has already has retained a vertical percentage, should not be required to make a further retention. If this is not the case then any entity trading loans or packaging them will be required to hold further retention each time a loan is traded. This increases friction resulting in trading and all forms of loan transfer being balance sheet inefficient and ultimately damaging market liquidity.

Repackagers, such as CLO managers, would be free from retention unless they originated loans direct from the end borrower.

This also provides regulators with information about how much alignment of interest investors require and, in addition to pricing of each tranche and the tiering between tranches, is a good measure of market health. This argument is also set out in Gordian's "Return Allocated Capital Equivalence" response to the first BCBS proposal and is available on the BIS website at:

Return Allocated Capital Equivalence, April 2013:
http://www.bis.org/publ/bcbs236/gordian.pdf

5. Regulatory Treatment

There are three main issues that affect bank investment or holdings of securitisations. These may be holdings for trading for temporary warehousing or for long term buy and hold to maturity investing. These are **capital, liquidity and treatment of securitisations vs. other types of bank asset**:

Capital risk weights

Capital risk weights for securitised tranches are calculated based on a mathematical model or a simple floor and not on the basis of the combined risk on the underlying loan assets and the relative sizes and positions of each tranche. The aggregate capital required for a portfolio of loans held by an originating bank and capital required if the same loans are used as collateral for a securitisation and all tranches are held by banks, is not the same. In fact, the aggregate capital required for the securitisation bears no relation to the capital required under BIS III (standardised approach). BIS III defines the aggregate capital that the originating bank must hold for the underlying loan portfolio but then does not use this quantum of capital as the basis for calculating capital requirements when the same loan assets are sold into a securitisation. The risk of the underlying loans is not changed when they are sold into a securitisation as long as the bank retains a percentage of the original risk and its interests are therefore properly aligned with investors (see Retention above). Furthermore the BCBS approach results in the capital required for a retained vertical percentage of the securitisation being different than the capital required for the same amount of the underlying loans! Aggregate capital required for banks holding securitisations is arbitrarily increased from the capital required for the same underlying loans by a factor of between 1.2 to 7.2 times (Source Bank of America, European ABS 15 January 2014). This is simply a tax on banks holding securitisation vs. holding the underlying loans.

We consider that a modified form of capital equivalence (the aggregate capital required for the loan portfolio before and after securitising should be very similar with additional capital required only for additional risks, such as derivatives embedded in the securitisation) should be used as the basis of the capital required for any bank holding securitised tranches. For a complete explanation see Gordian's two comments to the BCBS, available on the BIS website, at:

Return Allocated Capital Equivalence, April 2013:
http://www.bis.org/publ/bcbs236/gordian.pdf

Updated Return Allocated Capital Equivalence, April 2014:
http://www.bis.org/publ/bcbs269/gordianknot.pdf

We appreciated that the joint paper shares our concerns about capital charges (paras 10, 75 & 76).

Liquidity Rules

The new BIS liquidity rules (including the liquidity risk factors and caps) applied to securitisations come in two parts, the LCR & NSFR and are completely independent of the eligibility to liquidity facilities available from Central banks. We consider that all three should be have a common set of liquidity rules and these should be based on the eligible collateral that central banks are willing to accept, using their haircuts and cost of funds, as these change from time to time.

The BCBS (January 2014) represents that the Basel III liquidity standards are designed to achieve "two separate but complementary objectives":

- LCR – "to promote the short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient High Quality Liquid Assets ("HQLA") to survive a significant stress scenario lasting for 30 days";
- NSFR – "to reduce funding risk over a longer time horizon by requiring banks to fund their activities with sufficiently stable sources of funding in order to mitigate the risk of future funding stress".

Liquidity Coverage Ratio

The LCR considers 30 calendar days' behaviouralised cash outflows. All maturing liabilities in the next 30 days are separated by type and a behaviouralisation assumption is applied to create "an expected need for funds" which must be covered by HQLA subject to type specific haircuts. Retail deposits are assumed a run-off rate of only 3%, 5% or 10% on their scheduled maturity date (including on-demand and overnight deposits), depending on deposit type, while wholesale deposits assume 100% run-off (although non-financial corporate deposits assume 40%). These behaviouralised cash outflows are to be covered by a buffer of High Quality Liquid Assets ("HQLA"), made up of:

- HQLA Level 1 (predominately government bonds, similar to the UK's LAB);
- HQLA Level 2A ("AA-" or better covered bonds and non-financial corporate bonds); and
- HQLA Level 2B ("BBB-" or better non-financial corporate bonds; and "AA" or better RMBS).

To calculate the LCR, HQLA are subject to haircuts (15% to 50%) and caps (a maximum of 40% of total HQLA in Level 2 assets, with a maximum 15% of that 40%, i.e. just over 1/3rd, in Level 2B assets). The caps are a proxy for the cost and ability to liquidate assets of differing type during a 30 day period of market stress.

The caps on the amount of High Quality Liquid Assets ("HQLA") that banks may hold to comply with the LCR are expressed as a percentage of the bank's balance sheet, not the size or depth of the market, so the caps are not related to market liquidity, but to the size of the bank. This amounts to a barrier to entry or a tax on smaller banks in favour of larger incumbents. HQLA also favours covered bonds over securitisations, both of which can be based on the same underlying loans.

Net Stable Funding Ratio

The NSFR is designed to complement the LCR by considering the broader, strategic and long term liquidity adequacy of banks' balance sheets over a 1 year timeframe. The LCR, in contrast, has a different purpose and considers only a single 30 day liquidity shock.

The NSFR requires that stable funding > illiquid assets, which is communicated as a percentage:

$$\frac{\text{Available Stable Funding (“ASF”)}}{\text{Required Stable Funding (“RSF”)}} \qquad \text{(implying a target of >=100\%)}$$

Each liability type is behavioualised by assigning an "ASF" factor based on how stable the funding is expected to be, and each asset type is assigned an "RSF" factor to determine how liquid the asset is expected to be over the one year horizon. The tables below show a summary of the factors published in January 2014:

NSFR – January 2014

Asset categories	RSF
Notes, coins, CB reserves, interbanks <6mths	0%
Unencumbered Level 1 (Govts etc.)	5%
Unencumbered Level 2A	15%
Unencumbered Level 2B	50%
Excess Level 2B	50%
Loans lt 1year	50%
Res. mortgages and loans (gt 1 yr and lt 35% RWA)	65%
Other loans (gt 1 year and gt 35% RWA)	85%
Non-LCR qualifying securities	85%
Commodities	85%
Encumbered assets> 1year	100%
NPLs, fixed assets, defaulted securities etc.	100%

Undrawn irrevocable or conditionally revocable credit/liquidity facilities	5%

Liability categories	ASF
Capital	100%
Funding gt 1 yr	100%
Stable retail deposits	95%
Less stable retail deposits	90%
Non financial funding (lt 1 yr)	50%
Other funding (6 mth to 1 yr)	50%
All other liabilities	0%

This revision is an improvement on the original draft, however the ASF factors still skew the calculations towards traditional retail funded institutions with consumer loan books and does not map to the Bank of England's eligibility criteria for the Sterling Monetary Framework or the ECB's eligibility requirements.

For example, the NSFR does not adequately recognise the liquidity of securitisations vs. that of loans:

- Non-LCR qualifying securities (e.g. Consumer ABS): 85% RSF
- Residential mortgages and other loans (=>1 year but <=35% RWA) 65% RSF

These RSF factors treat a considerable portion of Bank of England Level B collateral (ABS backed by credit cards, student/consumer loans, auto loans etc.) as almost completely illiquid (with an 85% RSF) and actually ranks as less liquid than Bank of England Level C collateral (loan portfolios). Clearly it would be preferable if the BCBS and Central Banks had a common standard for assessing liquidity and ideally that standard should have a finely graded continuum covering a diversity of asset types, much as central bank facilities have developed over the past few years.

For "Other Loans", also at 85% RSF, there is no benefit from securitising these loans as although they may then be central bank eligible bonds (CMBS, CLO/CBO, etc.) they have an unchanged RSF factor.

These LCR & NSFR tests both create an incentive for banks to barbell the liquidity in their portfolios – holding high risk, illiquid, high margin loans and low risk, liquid government bonds and covered bonds, since the tests gives such little value to the liquidity of a wide range of high quality liquid assets, including senior tranches of securitisation. This can also be seen as an implicit support for the classical retail banking business model (long dated, first loss loans funded by on-demand deposits operating within a bank's high cost structure) to the disadvantage of other types of banking business models that hold higher quality assets, including senior tranches of securitisations.

In summary, securitisations are treated worse than some loans under the LCR and NSFR tests and these tests are not based on contractual cash flows alone but are a product of broad classifications of cash flows and overly simplistic behaviouralisation assumptions.

For a complete explanation see comments provided by Gordian to the BCBS on the current NSFR including an alternative methodology in April 2014. The core proposal is to publish the cash flow facts, with smaller "time buckets" providing significantly greater granularity, to regulators and to the market and to allow each market participant to apply their own behaviouralisation assumptions in addition to the regulatory standard. Asset data should also be available allowing market participants to make their own assumptions about the liquidity of each asset class.

For a complete explanation see Gordian's comment on NSFR to the BCBS, available on the BIS website, at:

http://www.bis.org/publ/bcbs271/gordianknot.pdf

Treatment of securitisations vs. other types of bank asset

Capital risk weights for bank holdings of covered bonds are lower than ABS senior tranches, despite the significant operating risk that an investor has on the issuing bank. Covered bonds enhance the issuance above the senior unsecured issuance of the bank by providing some additional collateral (typically higher than the capital ratio operated by the bank, so senior unsecured depositors lose collateral or equity, and accept an increasingly junior position as a result of issuance of covered bonds).

Other areas to consider

While we agree with much of what the joint paper covers it is important to point out some areas that are either not considered or under represented.

a) The paper makes some useful observations about the facts of changing patterns of securitisation issuance, it doesn't explain who the investors in the senior tranches were pre-2007, why these investors were the dominant force in the market and why they are no longer active.
b) While the joint paper comments favourably on the positive effects that securitisation may have on financial stability (paras 3, 29, 40 & 44) it does not explain how or why this may be the case. For example there is no discussion of comparative advantage. Similarly there is no description of the effects of securitisation on the efficiency of the banking system or the financial system overall.
c) The role of securitisations in reducing the cost and increasing the availability of credit to creditworthy end borrowers is only covered indirectly (paras 4, 43 & 44) and not as a driver of pricing and influencing the availability of credit to end borrowers.
d) There is limited discussion of central bank activity in these markets (para 56) despite the very large retained to repo "issuance" of recent years (2010 76.9%, 2013 57.8% of all European

issuance was retained. Source AFME) and there is no discussion about how to exit from very large central bank positions.

e) The paper does not mention what effect securitisation has or could have on transmitting the effects of QE to all borrowers, in particular those borrowers who cannot access the capital markets themselves, such as consumer and SME borrowers.

f) Further there is no discussion on the effects of securitisation in calculating the monetary aggregates, and only a very limited mention of how it may affect the management of and transmission of monetary policy.

None of these issues is simple, but if there is a genuine objective to re-start this market then these issues should also be addressed.

Summary

The Bank of England and ECB paper is a useful contribution to the debate on securitisation and is helpful in asking "what needs to be done to re-start this important market". We agree with most of the objectives.

However, as a tool kit for getting the market re-started it appears to start with a general assumption that only by selling all tranches of securitisations outside the banking system is securitisation helpful. Nor does it explain the reason for the absence of investors in the senior tranche, that these investors must be funded, why repo financing is both unstable and leaves tail risk back in the banking system if not properly backstopped. The issues of retention and very high regulatory requirements for both capital and liquidity (for both banks and insurance companies) are not resolved in our opinion. New standards are proposed and these would be set by regulatory bodies and or central banks. Our view is that standardisation should be based only on central bank facilities as these can be changed dynamically through time. This approach avoids the process of standards becoming difficult to change and tax payers effectively standing behind these standards.

All of these are impediments to a "better functioning securitisation market" and are effective barriers to re-starting this important market for banks, borrowers, and the broad economy. The endless series of regulatory proposals to increase capital charges, change liquidity treatment, provide financing at low cost via "retained to repo" transactions all combine to impede a private sector recovery.

Proposals for new banks, that invest in high quality, senior tranches of securitisations as part of their overall asset portfolio, bring capital and stable funding to this market. This would appear to be preferable to senior tranches being held by non-banks and financed by repo from banks as this brings mark to market instability back into the banking system.

Conclusion

We welcome the combined Bank of England's & ECB's joint paper and willingness to receive comments. A well functioning securitisation market brings many benefits;

- to all creditworthy borrowers, including consumers and SMEs, as it provides them with improved access to borrowing at lower cost and removes the asymmetry of QE, as to some extent securitisation levels the playing field and brings the beneficial effects of QE to all creditworthy borrowers, improving the cost and availability of credit throughout the real economy,

- to investors offering them a broader choice of both credit and funding products,
- to banks as originators, providing them with an alternative source of both capital and long term, maturity matched funding, improving operational leverage of their fixed assets and client relationships, and liquefying their balance sheets (both actually and equally importantly, potentially),
- to central banks, providing an exit from large holdings of ABS, to transfer retained to repo financings to the private sector, improving the quality of assets that may be pledged with central bank liquidity facilities, and providing an accurate ability to monitor changes in money supply,
- to senior depositors, providing long term funding for the banks and reducing their risk from encumbrance via covered bonds, and
- to regulators, improving liquidity and transparency of banks' balance sheets and enhancing financial stability.

Re-starting this important market is therefore of paramount importance to the real economy. Hindering this market are new capital and liquidity regulations that impose higher costs on banks and insurance companies when investing in securitisations. These are pervasive and effective "taxes" on the securitisation market that are a mistaken legacy from the financial crisis of 2007-9.

The effect of these regulations is to drive investing in securitisations outside the banking and insurance industries. While this may appear a healthy transfer of risk it is tempered by the facts that these are unregulated investors, frequently funded by banks on a short term repo basis, and so exposed to mark to market risk which, as demonstrated in 2007-8, is fundamentally unstable.

Regulations that encourage a build up of non-bank investments in the smaller, more risky, junior tranches of securitisations may be healthy for the banking system. But the senior tranches, that represent de-levered (or over collateralised) loan portfolios, are high quality collateral that appeal to a wide range of investors. These are best funded on a hold to maturity, non-mark to market, basis by banks (and insurance companies) with strong capital and deposit profiles, properly backstopped by central banks. This includes these activities within the regulated space, ensures proper regulatory supervision while also aggregating this activity into money supply figures.

Appendix 1

Responses to Questions

1. Do respondents agree with the benefits of a well functioning securitisation market as outlined in section2?

> Section 2 outlines most of the benefits of a well functioning securitisation market. However, it makes the assumption (para 36) that long term investors such as Insurance Companies and Pension funds are the natural buyers of long term assets and so are the natural investor base. As pointed out above we consider this to be a misperception or wishful thinking. We would add to para 39 the benefit to banks of having the ability to liquefy their balance sheets by securitising, even if they do not currently securitize to their maximum capacity. The perspective of securitisation as a substitute for raising capital (equity, AT1, T2) and long term, maturity match funded debt, by giving a bank CFO that choice, is not fully considered.
>
> The effects of securitisation on QE are not discussed. Our perspective is that QE benefits only those borrowers that already have direct access to the capital markets (such as Governments and large corporates). Securitisation provides indirect access to the capital markets for SMEs and consumers via their banks and this allows borrowers lower cost and better access to funds especially when the banking system is in stress or is being re-regulated or is chronically inefficient.

4. Do respondents agree that market liquidity may be barrier to a well functioning securitisation market?

> We consider that market liquidity is a consequence of a well structured product that appeals to and is actively invested in by a wide range of different type of investors. Liquidity cannot precede a well functioning securitisation market. Therefore the question is misplaced – liquidity cannot be a barrier.
>
> It is also possible that the regulatory definition of liquid assets will result in banks hoarding those "liquid" assets that comply, perversely making them less liquid.

6. Do respondents think that a liquid market for qualifying securitisations used for funding would result from a "qualifying certification"?

> Again we think the question is a little back to front. You can decide that something "qualifies" and deserves "certification" and it is possible that investors may value it and liquidity will develop over time as more investors tread this path. But qualification and certification cannot ensure the development of a liquid market. In contrast, if central banks published their haircuts and cost of funds for a wide range of securities this is a direct and effective way to communicate liquidity appetite to the market. Private counterparties would be highly likely to reference these guidelines and benchmark their own liquidity measures on them.

7. These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a "qualifying securitisation"? What are the associated risks?

> Our view, as set out above, is that each agency has its own opinion about the types of security it values and wants to "certify" and that these views will change over time. Establishing a hard and fast final set of principles is perhaps too ambitious for a diverse market of credit sensitive securities that are based on thousands of underlying loans. We accept that central banks will change what they regards as eligible for discount and they will change both the haircuts and cost of funds based on many issues. These are what matter in real time and so it is preferable to make these decisions public and fully transparent than to create some new set of principles or qualifying requirements.

8. Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?

> Harmonising the standards of loan level delinquency and default would prove valuable to investors in securitisations and in bank securities. Auditors could then independently provide more meaningful comparative data.
>
> Providing loan level data is valuable to a few investors with the systems and expertise to handle that glut of data. Having fixed standards for reporting tends to result in reporting achieving only the lowest common denominator. Our preference is that each issuer provides as much data as they are able to and that they compete to exceed the standard which we consider the minimum requirement. In well functioning capital markets investors will reward issuers that provide the best level of transparency and service. So a compromise is to require a set of standard minima but to make it very clear that this is only the minimum requirement and to encourage issuers to be responsive to investors' requirements for additional information. Harmonisation of data across issuers is useful but very hard to do since each issuer is dealing with very different underlying loan portfolios and many use differing measures of delinquency and losses. No matter how similar the data may appear it always requires some form of recalibration to be able to look at different issuers on a consistent basis until a standard has been published and issuers are reporting on a common basis.

9. Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses, investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?

Prospectuses, all issuance documentation and investor reports should be freely available to all investors before issuance (this would be a sample report) and during the life of every transaction. A centralised location for all of these would be valuable in simplifying getting hold of these documents and this may help bring new investors into the market. However, a more important initiative is to ensure that full deal documentation is available to investors to analyse before each deal is priced and sold. The absurd process by which investment banks only provided "internal and not for external distribution" material to investors has to end.

Standardisation of prospectuses and investor reports is more difficult since each asset class requires a different set of information. Setting a minimum set of requirements, for each class with the clear understanding that these are minimum requirements not thresholds, and encouraging all issuers to exceed the minimum is preferable. This is probably best achieved with a broad set of principles.

11. In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

Providing annonymised loan level data will be useful to some larger investors with the systems and expertise to process this data and to extract information from it. It must be recognised that not all investors will prove either willing or capable of doing the detailed credit work to understand the legal structures, model the cash flow waterfalls and to run surveillance on each in real time. Credit is both an art and a science and so investing requires proper skills and process to be effective. Secondary markets work best when there is full transparency over all transactions, reporting (with a reasonable delay) the price at which transactions are executed gives investors significant comfort that they are dealing in an open and fair market.

12. Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could easily be produced?

Again benchmark indices are helpful when a market has some degree of critical mass and enough investors are active to find a benchmark useful.

13. Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

We prefer not to support the use of ratings by integrating them into public processes. However, we support a diversity of opinions as long as they aren't hard wired into regulatory requirements. Investors should not be encouraged to rely on third party credit assessments or on arbitrary props.

16. Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

Developing the concept (introduced in Section 2, para 50) of "Liquidity products" and "Credit products" is helpful to appreciate that liquidity products are a low return, "capital preservation" investment and so will be bought by funded investors along with many types of own money investors. Funded investors should either have long term liabilities or have short term liabilities appropriately backstopped – this means they must have access to central bank facilities and so must be banks. Central banks provide liquidity to banks against their whole loan portfolios so they should be more willing to backstop over-collateralised or de-levered loans. Non-bank investors with repo funded holdings of securities, even with significant haircuts to protect the lenders (usually banks), are exposed to contagion risk, especially when many investors hold similar assets and similar sources of funding.

A downward spiral of declining prices (not necessarily due to deterioration in credit quality), increased calls for margin and higher haircuts can result in more sales and lower prices. Non-banks have no exit from this spiral as higher haircuts and declining prices will ultimately consume all available equity. High quality, well capitalised banks are a policy option that can bring new capital into securitisation markets to invest in senior tranches, filling the gap caused by a lack of senior investors that has existed since 2008. This gap has been temporarily filled only by central bank purchases or retained to repo financing. This policy choice provides both an exit for inflated central bank balance sheets and restores the normal functioning of the private sector market.

17. Beyond securitisation, might there be other ways achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?

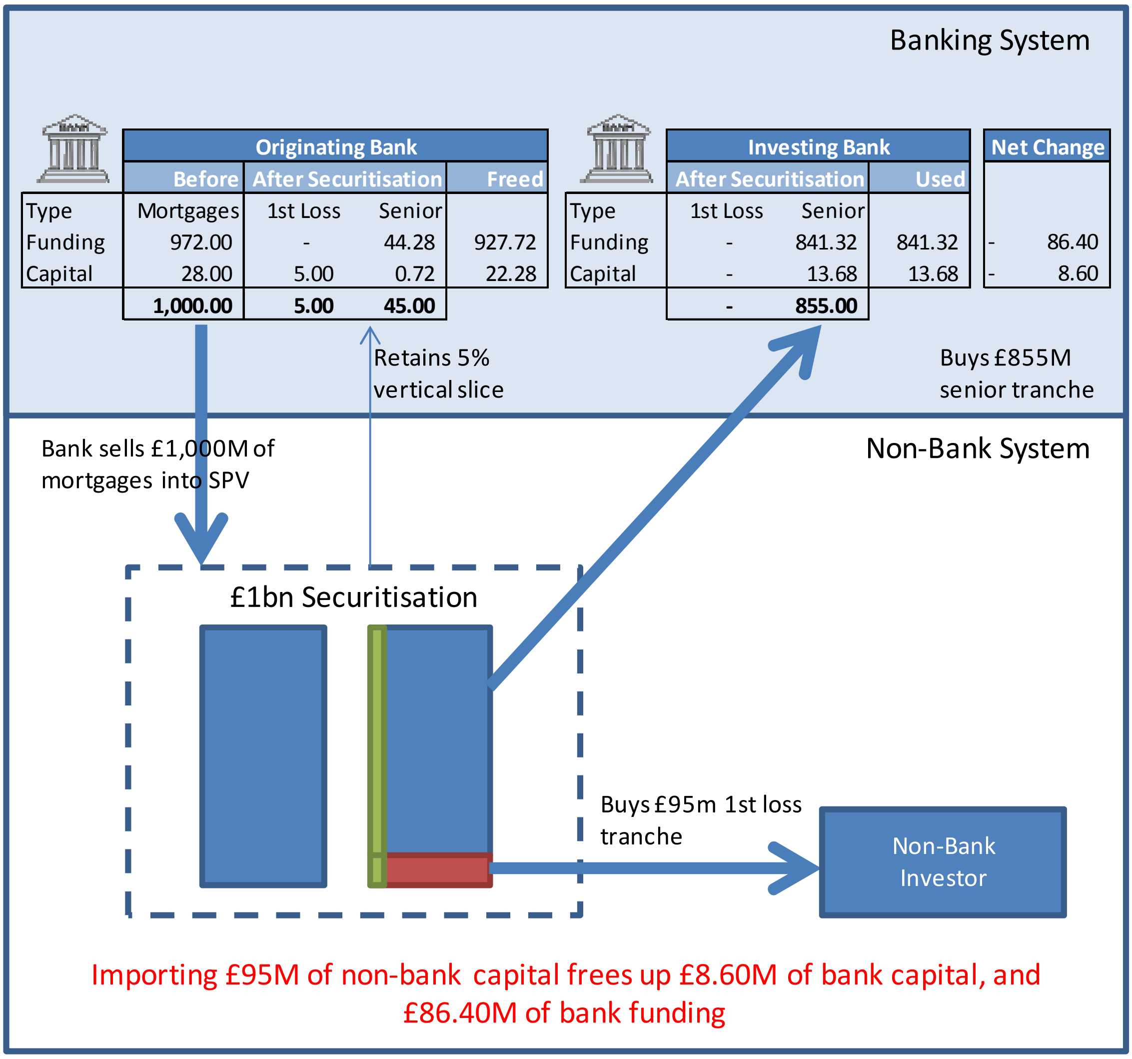
Covered Bonds are regularly seen as an alternative to securitisation and are generally given preferred treatment vs. securitisations in all regulatory tests and requirements. As pointed out above in section 5, Covered Bonds are not true sales and so the loan assets remain on the originating bank's balance sheet. They are not maturity matched (although they do provide longer term funding than typical deposits) and the provision of overcollateralization (the cover loan pool) subordinates senior unsecured depositors. Effectively the originator is selling the senior tranche of a securitisation, which is not maturity matched to the loan pool, and is retaining all of the junior tranches. Covered bonds therefore provide term funding and very little capital to banks, do not materially improve the banks risk profile while making the positions of senior unsecured depositors materially worse – this final risk is underwritten by national deposit insurance schemes. On balance we can see no reason why covered bonds are preferable to securitisations from the perspective of any of; the investor in the covered bonds, the issuing bank, senior unsecured depositors, or the national insurance scheme. Why they have such favourable regulatory treatment seems to be purely a matter of history and regulatory inertia.

Synthetic securitisations are an alternative to funded securitisations. They in many ways are the flip side of covered bonds, in that they provide capital and not funding to the originating bank. The originating bank retains the underlying loans and references them in the synthetic securitisation. There is significant operational risk by the investor on the banks (similar to the risk taken in the covered bond loan pool and the bank's ability to substitute loans) but senior depositors are not disadvantaged as no additional collateral (equity) is transferred.

On balance, we consider true sale securitisations, with vertical retention by the originator, to be the preferred policy choice. Non-banks should hold the junior tranches, providing significant capital to the banking system, while a combination of banks, insurance companies, own money investors and non-banks that are long term funded are the optimal holders of senior low risk tranches from a financial stability perspective.

Appendix 2

The diagram below demonstrates the effect of a bank selling mortgage loans into a securitisation; the senior tranche is bought by a bank and the junior tranche by a non-bank. The risk weights assume a **standardised model** is applied.



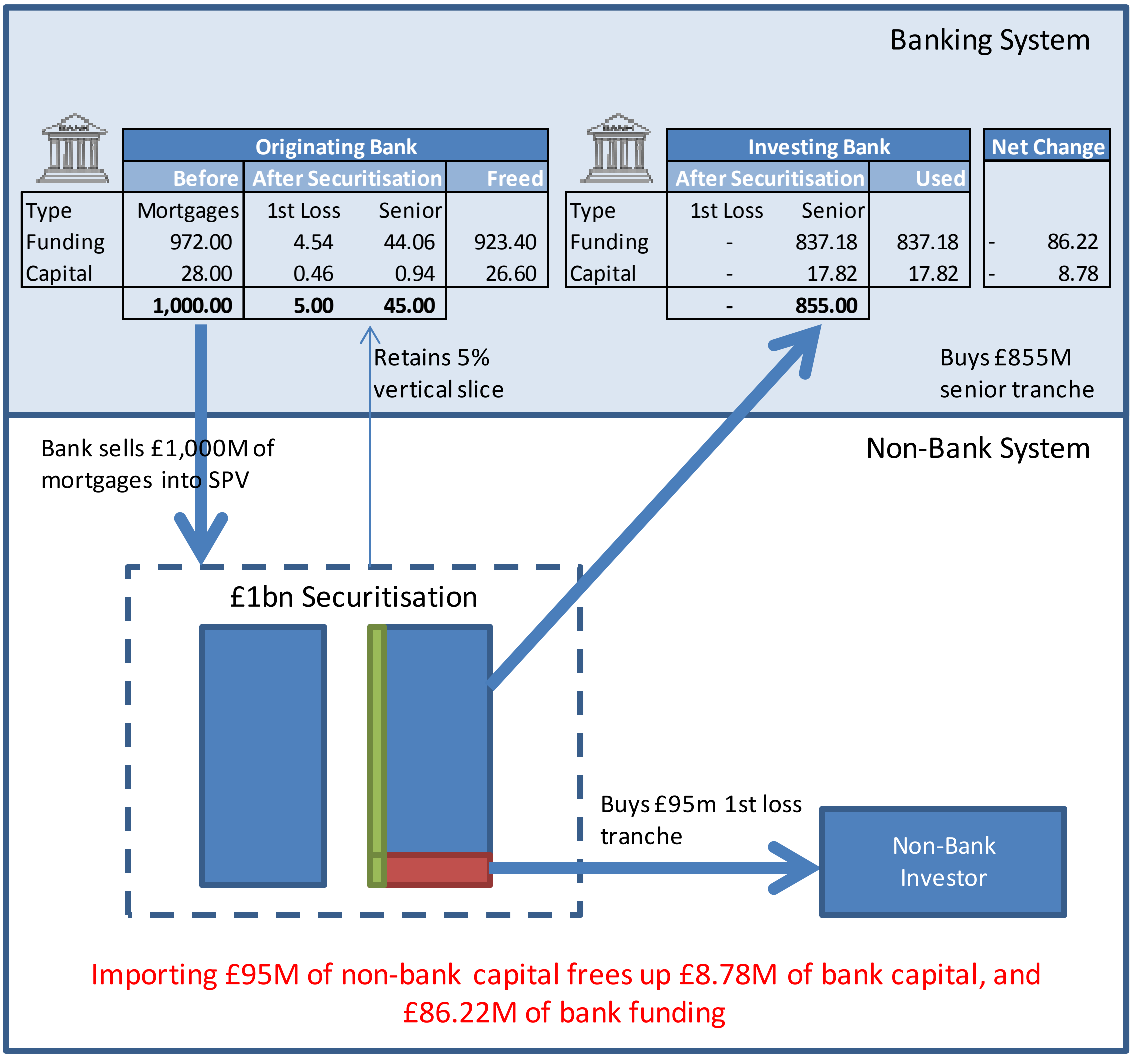
Prior to securitising, the originating bank allocates £28M of capital against the £1B of mortgage loans it has on its balance sheet (applying a 35% risk weighting = 35% of 8%), and fund the remaining £972M.

If these loans are then securitised into a simple 90% AAA senior / 10% junior 1st loss structure, the bank retains 5% of each of these tranches as a vertical slice. Together this retention amounts to £50M. Each 5% tranche retention will itself require a capital allocation: £5M fully capitalised for the first loss tranche, and £0.72M for the senior tranche; the bank will fund the remaining £44.28M. The net result of the securitisation process is that the bank has freed up £22.28M of capital and no longer needs to fund £927.72M of loans.

The remaining 95% of both of the tranches will be sold to the market. We assume a non-bank investor purchases the non-retained balance of the 1st loss tranche of £95M and that a bank investor (in reality several banks), purchase the remaining £855M of the senior tranche. The investing bank will have to allocate £13.68M of capital to its holding of the senior tranche under the standardised approach, and fund the remaining £841.32M.

The net effect inside the banking system is a reduction in capital requirement of £8.60M (= £22.28M less for originator minus £13.68M deployed by banks investing in the senior tranche) and a reduction in funding of £86.40M (= £927.72M minus £841.32M). The non-bank investor's £95M purchase of a 1st loss tranche freed up £8.60M of bank capital and £86.40M of funding to be re-used for credit generation.

The diagram below shows the same securitisation process and distribution, but this time uses the **RACE Approach** model for risk weights and capital allocation, rather than the standardised model. The assumptions underlying the risk weight calculations were derived from a recently issue mortgage securitisation that approximate a 90/10 structure.



Using the capital equivalence approach the originator would hold 5% of the original capital against their 5% vertical retention of the two tranches, totally £1.4M. This would be split: £0.46M for their £5M 1st loss retention (risk weight of 115.50%) and £0.94M for the £45M senior retention (risk weight 26.06%). As a result, the bank has seen a reduction in its capital requirement of £26.60M (vs. £22.28M for the standardised approach) and a reduction in its funding requirement of £923.40M (vs. £927.72M).

The investing bank(s) will use the same 26.06% risk weight to assign £17.82M of capital to their purchase of £855M of the senior tranche (vs. £13.68M for the standardised approach).

Comparison:

The net effect inside the bank system of this reduction for the originating bank, and increase for the investing banks, is therefore very similar to the standardised approach: the non-bank investor's £95M purchase of a 1st loss tranche freed up £8.78M of bank capital (vs. £8.60M for the standardised approach) and £86.22M of funding (vs. £86.40M) to be re-used for credit generation.

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Dated July 4, 2014

Comments on

"The case for a better functioning Securitization market in the European Union"

To the ECB and the BOE,

A few preliminary statements are necessary to understand the perspective of our comments.

GTI Asset Management[1] has been historically active in securitization. As founder of our group, I have been involved with securitization since 1983, when I worked in New-York. Upon my return to France in 1989 and the creation of our group, we have been at the forefront of innovation and realized the first RMBS for Crédit Foncier (1991), first securitization of municipal loans (1995) and we have been heavily involved with securitization of trade receivables which we initiated in 1998.

We have arranged for over € 8b of deals and today, we manage approximately € 2b of assets.

As a unique independent actor in the securitisation field in Europe (we are not affiliated with any financial institution, bank, insurance company or otherwise), we have always offered an alternative view of the financial system, and the benefits of securitisation.

This unique positioning explains that our views are sometimes different from the generally accepted opinion.

We appreciate the ECB/BOE request for comments in the 'The case for a better functioning securitization market in the European Union discussion paper, and this renewed opportunity to expose our views on how to enhance the contribution of finance and securitization to the greater economy.

[1] formerly "Gestion et Titrisation Internationales SA"

There are a few preliminary points that deserve to be mentioned:

- Securitization is not the cause of the crisis; it certainly allowed the spreading of credit difficulties, but it is not their cause. The cause should be searched in "human" (or not so human) behavior, where greed and the lack of ethical boundaries have induced grossly improper behavior. In other words, banks and other participants can be faulted, as well as investors who did not perform appropriate due diligence. And regulators could also question whether increased capital rules tend to push financial institutions towards areas of greater rewards (and therefore higher risks) to continue serving appropriate dividends. But it is always easier to fault the hammer than one's own skills.

- Liquidity is often pronounced as a buzz word and a prerequisite of securitization to fund the economy. We believe this is a gross misconception. Funding the economy means that intermediaries build the best possible instruments to satisfy duration requirements of financial institutions such as banks, insurance companies and retirement systems. May be banks might need liquidity, but insurance companies and pension funds have long term missions and are long term investors; they rarely need liquidity.

- Our perspective is an improved funding of economic needs, not the development of securitization per se. We are in France, where making loans is a regulated activity and few countries have adopted such an extreme position; in our geographic and legal environment, we are a strong proponent of deregulating the distribution of credit. This would diversify funding channels and necessarily provide better funding to economic agents. Moreover, bypassing the banks will avoid the excessively narrow channeling of funds, which, as we have seen, bears the seeds of global crunch.

- Finally, we believe that most criticisms against tranching are unwarranted and that tranching ought to be rehabilitated to some extent. One of our target clients are SME's; SME's do default and these defaults are a "natural" event. If we want to finance SME's through securitization, and if tranching is excessively penalized, investors will bear the average risks of the whole pool; few of them will be interested. If, on the contrary, tranching can be used to segment risk levels, and duration, the universe of potentially interested investors will be greatly expanded, as they will have a two dimensional choice along risk and duration. The current stance where tranching is, in a sense banned, but where securitization is expected to help fund SME's is mechanically doubtful.

We have answered the questions of the survey, and our responses are in part a reflection of our economic DNA; they are also the views of an expert team who has been in securitization since its inception in the early 80's in the US, and who has led several major innovations in Europe, but has always remained on the safe side of innovation.

We would like to thank you for this opportunity and for your attention to our contribution.

Richard Weiss

for Groupe GTI

GTI
Asset
Management

July 4, 2014

Comments on

"The case for a better functioning Securitization market in the European Union"

1. *Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?*

It would be difficult for anyone with a normal mind to challenge the benefits of anything that is "well-functioning". So the answer is necessarily yes.

The broader issue is the actual purpose of securitization; if it is a means exclusively dedicated to facilitate refinancing by banks, then it only serves to increase lending concentration and risk.

The economically valuable purpose of securitization is to diversify and hence stabilize the funding needs (notion of holding financial assets) and the provision of credit (making the initial lending).

Some of the other benefits outlined about improved credit conditions (p7) are more questionable such as the links between (i) banks getting cheaper funding, and (ii) broadly positive credit conditions for the real economy. We also wonder whether private interests are necessarily committed to funding the public in any situation.

The paper clearly outlines how banks may benefit from securitization in their quest for cheaper funding; meanwhile, non-banks and other contributors to the real economy appear disregarded.

Supporting securitization as a risk transfer mechanism for banks may consolidate the banking system, but hardly benefits the economy as a whole.

2. *Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?*

The impediments highlighted in this section are certainly the most sticking, and immediately visible ones. But there are also other impediments.

The lack of understanding and education, are certainly also a major hurdle. Regulators, journalists and many others have pointed to securitization as the major culprit of the crisis and this bashing has left the technique significantly scarred. A major educational effort should be undertaken, with all participants, and regulators.

The insistence on standardization is a double edged argument. Standardization constrains the possible uses of securitization and would provide an excuse (again) to those who do not want to perform due diligence.

Rating may be an impediment to many investors; but the solution is not to change rating agency methodology. It might be helpful to demand that ECAI identify the reasons for a "lower rating" (for example country rating ceiling) but investors should also be encouraged to challenge ratings, and even to work without ratings. Systematic rating requirements are an easy excuse to avoid investor's own due diligence but they fail provide safer, or more predictable products ; in the past, widespread surprise in the face of rating adjustments are an example of similar failures.

The low cost of central bank funding is definitively an impediment to a market-based, objectively priced funding technique such as securitization. In a separate paper we will expose why and how continued inexpensive funding achieves results opposite to those sought in the first place.

Indeed transparency, structure details and underlying assets characteristics are crucial to a comprehensive analysis and sound investment decisions; that is what investors (and other players in this field) should be looking for.

Credit rating agencies are attentive to assets quality. The fact that values move and that ratings are therefore adjusted, cannot and should not be countered, as it is an unavoidable reality of life.

3. *Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?*

Impediments perceived by issuers are well described. However, issuers should bear the consequences of their own actions, or inactions. They provide funding at a certain interest rate and if no other entity is willing to provide funds at the same cost, it simply proves that the rate is too low, their pricing is too cheap.

This is one of the major flaws of "universal banking", where banks undercharge on lending (an activity where prices are easily comparable) and make it up through other services. Securitization cannot transform a loss generating activity into a profitable activity.

The discussion paper states (89) that rating agencies requiring higher credit enhancement is a "problem", and that rating caps "reduce the information content itself" as investors cannot distinguish between a true single-A and a "rating capped" single-A that otherwise could achieve a higher grade. But credit ratings are an opinion, just an opinion, and participants may choose to hear or not hear this opinion. They could also try to understand the rationale (if any) for the opinion.

4. *Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?*

Liquidity is not really a barrier. It is a barrier to those players whose purpose is to trade in and out of paper. But entities who finance the economy (insurance companies, retirement systems, pension funds) just need high quality, high yielding assets. The need to sell these assets unexpectedly (ie the need for liquidity) in quite uncommon.

The discussion paper itself notes this contradiction, rightly stating that securitized paper is mostly held by buy-and-hold investors, and outlining low second-market activity. There is no vivid second market simply because investors are mostly buy-and-hold investors!

5. *The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?*

Clearly to be "qualifying" anything ought to be "consistently and predictable understood". The more pertinent qualification ought to be that risk-return be clearly illustrated.

As rightly outlined in the point 102, one term cannot capture the quality of all products, and rather, as outlined in point 100, we ought to focus on defining 'principles', that actors may or may not follow in describing the products they offer. A similar approach was taken for the EuroPP charter in France, where a positive market evolution, was created.

A basis on which to elaborate such principles could be as follows:

- transparency regarding the underlying assets, and their behavior over time;
- explanations and details of the assumptions made in structuring the deal, on cash-flow, delays, defaults, etc together, in each case, which comparables;
- commitment to provide detailed, on-going information.

The principles outlined in Box 3 are certainly laudable. However two major pitfalls should be avoided:

- executive standardization which would create an anti-competitive environment and possibly promote even more reckless behavior than was seen a few years ago;
- The total impairment of innovation, thereby eliminating all possibilities to address new and evolving funding needs.

6. *Do respondents think that a liquid market for 'qualifying' securitizations used for funding would result from a 'qualifying certification'?*

Setting aside the question (answered above) referring to whether liquidity is useful or necessary, we do not think that "qualifying certification" will lead to liquidity. First we believe the concept of certification is dangerous as it raises numerous questions as to who certifies; in particular certification by trade groups would be equivalent to self-infatuation.

But, even worse, certification will induce many investors to rely on such certification and to by-pass due diligence. That's where the danger lies.

We believe that the risks associated with the introduction of any kind of comforting qualification far outweighs the potential benefits.

7. *These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?*

We do not believe that authorities or market participants should develop frameworks for egibility criteria. The criteria ought to appear in a legal corpus, thereby ensuring that inappropriate use of the qualification may have dire consequences. Letting participants establish the framework is comparable to letting players set their own rules of the game.

Authorities and participants should jointly develop the general principles, each group hearing the constraints and purposes of the other group (sometimes a true discussion seems difficult to initiate); once principles are established they should be set in a legal framework and not left to authorities, trade groups, participants, or similar possibly biased groups.

8. *Do respondents think that harmonization and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?*

Software and access to individual loan data should be a recommendation, and should not be monopolized.

We would welcome the opportunity to use and contribute to central databases that provide loan level information on financial assets such as loans (corporate and personal), mortgages, receivables, etc... and an indication of credit quality of companies should also be distributed, subject to privacy constraints.

There are a number of frameworks whereby actors share information on this type of data; we think for instance of Fiben in France, which is a rating system of companies' credit quality provided by the Banque de France but unfortunately exclusively to credit institutions. Such frameworks should be equally open to all market participants, in order to create a uniform informative environment where everyone can best assess the quality of financial paper that is being created, held and traded. This would also facilitate the creation and use of robust benchmarks.

9. *Do respondents think that initiatives currently undertaken by authorities in the area of standardization of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardized investor reports in a single location be helpful to securitisation markets?*

In an activity where diversity is the name of the game, standardization is really the wrong direction. It provides an easy excuse to those who do not want to perform their due diligence, but it is really a dangerous path.

And standardization can hardly fit all the diverse needs of all types of securitization of all types of assets.

10. Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?

Clearly, more information on borrowers' credit data together with investors doing their own research and due diligence will provide a better functioning market.

Credit registers are a very helpful tool both to analyze intrinsic credit risk and to provide a yardstick in order to compare different securities. To the extent possible, all granular assets should be covered including mortgage loans, personal loans, SME loans.

Our country is, as usual, a special case:

- Positive credit registers do not exist;
- The Banque de France establishes a credit score (and maintains other credit related data) for SME's, but these data are kept secret and reserved exclusively to credit institutions who do not divulge them. Even in an aggregated way!
- Confidentiality could be preserved by barring the disclosure of any information pertaining to a segregated individual or corporation.

11. In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardized data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

Of course, providing industry level macroeconomic data would provide a yardstick against which the data (static data as well as performance data) of individual securitizations could be compared.

And if individual loan level data were made available, investors could make their own risk-reward analysis and would certainly make more informed, better decision.

To help participants use these data, it would also be necessary to provide extensive, positive education.

12. Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

Indices are a useful benchmark. However, the variability of their performance (for example along economic cycles) may frighten some investors, and indices cannot capture all the diversity of specific segments.

For example, when looking at SME debts such as trade receivables, performance varies widely across industries. To compensate for these variations, we add structural features that balance the discrepancies among sectors.

Indices could hardly take these features into account.

13. *Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?*

Our position has always been that a rating is an opinion and nothing more. Agencies describe some of the logic that they use to justify their opinion – which is more than many opinion dispatchers do – and each party should deal with this.

Providing information such as "the rating would be better if my country or swap counterparty were better rated" is in the domain of childish play. If the investor does not know this, he should not invest.

Transparency is not lacking in this domain as country and counterparty ratings are well known.

14. *How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?*

As an independent group, we are not accustomed to fighting factual realities. We tend to find ways to get around the difficulties. Of course, it would be easier if... but that is not the situation and we have to live with it.

I would like to remind the reader that France introduced bank accounts falling outside the servicer's insolvency estate and we saw no meaningful development of securitization.

15. *With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?*
16. *Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitization markets?*
17. *Beyond securitization, might there be other ways of achieving (some of) the benefits of securitization as outlined in Section 2? What might be the associated risks of such options?*

Regardless of how the technique is named, the features listed in box 2 are helpful in order to better irrigate the economy with funding. Securitization is just the only way (other than banks with all their intrinsic dangers).

Rather than concentrate on "policy options" and details, it would be much more productive to attempt a major educational drive and admit that, after all, securitization is not as bad as once imagined.

All the rest will follow.

18. *Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitizations that are more amenable to risk assessment? Are there any obvious unintended consequences.*

These principles seem appropriate, although the devil is generally in the details.

However the requirement to avoid delinquent loans does not seen warranted (some delinquent loans may perform better than current loans); similarly the requirement to have only first ranking security interest seems excessive.

Similar comments would apply regarding external credit assessment institutions.

Richard Weiss

for Groupe GTI

4 July 2014

Dear Sir/Madam

The Bank of England/European Central Bank discussion paper on the case for a better functioning securitisation market in the European Union

The IMA represents the UK-based investment management industry. Our members include independent asset managers, the investment management arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. Our members manage investments worth more than £5 trillion for their clients, who are UCITS and other authorised funds, pension funds, insurers, sovereign wealth funds and individuals. Ultimately, much of what they manage belongs to the man in the street through their savings, insurance products and pensions. Their interest in this consultation is therefore in their role as the "buy side" of the market, accessing capital markets on behalf of their clients.

We welcome the opportunity to respond to the discussion paper on the case for a better functioning securitisation market in the European Union.

The IMA is supportive of the aims set out in the discussion paper and the principles based approach it proposes for differentiating the securitisation market. Our members agree that:

- the liquidity rules under Basel III do not act as a disincentive for banks to originate and invest in these instruments. Regulators should, **as a minimum**, consider extending the scope of securitisations that could potentially qualify as high quality liquid assets (HQLA) under Basel III and to align it with EIOPA's criteria of securitisations that qualify for lower capital requirements under Solvency II.
- a liquid market for qualifying securitisations would benefit from a qualifying certification.
- markets for less mainstream securitisations would benefit from improvements to the availability of data to investors and work should be done to standardise to the structure of disclosures made to investors.

The response outlined below, represents the general views of investment managers and their clients as institutional investors on the development of securitisation market in Europe. We do not respond to each question individually.

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The IMA looks forward to continued engagement with the Bank of England and the European Central Bank on how this market can be further developed and revived.

Yours sincerely,

Pamela Gachara
Policy Adviser, Markets

IMA Response to the Bank of England/ European Central Bank discussion paper on the case for a better functioning securitisation market.

The IMA welcomes the opportunity to respond to the discussion paper on the case for a better functioning securitisation market.

Securitisations are an important asset class for our members as the investment decision-makers on behalf of a range of investors, including insurance companies, pension schemes, UCITS, AIFs and other institutional investors. Securitisations provide:

- a mechanism through which (non-bank as well as bank) investors can provide funding to companies in the real economy,
- an additional means to diversify investors' exposures to debt securities, in terms of the underlying credits, and liquidity, and
- a mechanism for banks to transfer risk, reducing the likelihood of being capital constrained, therefore enabling them to make new loans and reallocate capital.

However, despite the wider benefits, the issuance of securitisations in Europe available to non-bank investors remains low. In 2013 total issuance was €181bn a fall of 28% from 2012. Of this only €76.4bn (less than half) was placed with third party investors. This is due to regulatory uncertainty and weak economic conditions. This in turn has limited the liquidity in this market.

For this market to be revived, it is imperative that the liquidity rules under Basel III do not act as a disincentive for banks to originate and invest in these instruments. Regulators should, **as a minimum**, consider extending the scope of securitisations that could potentially qualify as high quality liquid assets (HQLA) under Basel III and to align it with EIOPA's criteria of securitisations that qualify for lower capital requirements under Solvency II. These are securitisations with the following underlying assets:

- Loans to small and medium-sized enterprises (SME)
  - Leasing
  - Residential mortgages
  - Auto loans
  - Consumer finance
  - Credit card receivables.

Banks should also be allowed to include commercial real estate securitisations as part of their HQLA. This is an asset class that is currently excluded from the definition of high quality "Type A" securitisation under draft Solvency II Delegated Acts making the definition unnecessarily restrictive. In addition, the list of assets that may be eligible for HQLA should not be a static nor definitive list. Rather it should allow for those asset classes or transaction structures that are not included currently to be considered in the future.

The IMA agrees with the paper's assessment of the impediments to investors' ability to invest in this asset class, including:

- the stigma attached to the asset class following the financial crisis. This has limited institutional investors' willingness to allow their asset managers to invest in these instruments.
- the risk retention requirements under the CRDIV/CRR and AIFMD do not ease the identification of qualifying instruments and therefore investment in this asset class
- lack of market data for less developed asset classes e.g. ABS backed by SME loans.
- sovereign ratings caps applied to ABS from certain EU countries that mean that they are treated more harshly than their credit performance would imply. This would:
    - limit institutional investors' - specifically insurers' - ability to invest in these assets due to the higher capital charges under the standard model that would be applicable under the proposed Solvency II rules,
    - limit asset managers ability to allocate funds to these assets due to mandate and investment guideline restrictions, and
    - without further information, make it difficult for investors to distinguish between a true single-A rated securitisation and a rating-capped single-A securitisation.

The revisions to the draft Solvency II rules reducing the capital charges for high credit rated securitisations backed by certain categories of assets are welcome. However, these changes may not be sufficient to encourage insurance companies to invest in these products as the proposed capital charges remain very high relative to other fixed income products such as corporate and covered bonds. In addition, there remain severe cliff effects between the treatment of AAA rated and non-AAA rated securitisations. For insurers to invest in these products a graduated approach to risk is required; or better still, a removal of such hard-edged usages of credit ratings in regulatory definitions (in accordance with the wider EU policy of addressing over-reliance upon credit ratings).

Our members are supportive of the proposal to define qualifying securitisations as securities 'where risk and pay-offs can be consistently and predictably understood.' This definition, in addition to the principles that would identify such securities, offers enough flexibility to the market to create instruments that cater for the needs of market participants. It is important that in the long term these characteristics remain principles-based.

Our members agree that:

- A liquid market for qualifying securitisations would benefit from a qualifying certification. There may be merit in establishing an independent body to certify these instruments and, whilst more work may need to be done, focus should be to build up on the work of existing initiatives.
- Markets in riskier, less mainstream securitisations, such as SME-loan-backed ABS, would benefit from improvements to the availability of data to investors. This information should be made available to investors at a minimum cost to ensure accessibility and encourage investors to use of the data.

- The work should be done to standardize the structure of disclosures in prospectuses and investor reports across Europe to promote cross-border investment in these assets. This would be best accomplished through ESMA rather than through national initiatives.
- Whilst we are supportive of prospectuses and standardised investor reports being available in a single location, in practice, investors are likely to want to access any information depot through existing commercial information providers and the depot must provide wide access and licensing at low or no cost.
- Facilitating investor access to credit data would support the re-emergence of the securitisation market. Credit registers would be helpful in providing further information on an anonymised basis and to ensure that the borrower's data is protected. It is important that data protection laws across the EEA allow for this information to be provided on a unilateral basis.
- Additional information where sovereign and ancillary facilities ratings caps are applied should be provided. This would help reduce the mechanistic reliance on credit ratings and assist investors sense checks their internal ratings with a third party rating.
- There is a need to address the differing insolvency treatments of counterparties across the EEA and consistent recognition of bankruptcy-remote vehicles and arrangements. This would lower the costs and risks of securitisations and promote further investment in these assets.

INREV Response to Bank of England and European Central Bank Discussion Paper on the case for a better functioning securitisation market in the European Union, dated 29 May 2014

Introduction

INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. We provide guidance and information related to the development and harmonisation of professional standards, reporting guidelines and corporate governance within the non-listed property funds industry across Europe. In addition, INREV undertakes research and surveys of the industry and constructs the INREV Index which covers the performance of institutional non-listed real estate funds investing in Europe.

INREV currently has 355 members. Our member base includes institutional investors from around the globe as well as investment banks, fund managers, fund of funds managers and advisors representing all facets of investing into the non-listed real estate funds industry through both equity capital and debt capital.

Our fund manager members manage 461 European non-listed real estate investment funds with a combined Gross Asset Value of EUR 274.1 billion, as well as joint ventures, club deals and separate accounts for institutional investors. INREV's members represent almost all jurisdictions of the European Union's internal market and a range of underlying long-term investment vehicle structures that support European economic stability, job creation and growth.

We welcome the opportunity to comment on the Bank of England/European Central Bank Discussion Paper on ways to improve the way that securitisation works in Europe.

General comments

Commercial Real Estate (CRE) plays a central role in our built environment. It is generally considered to include not only offices, shops, logistics and industrial space, but also professionally managed rental housing, student accommodation, assisted living, hotels and leisure.

According to European Central Bank figures, real estate in its various forms accounted for more than 17% of value added and more than 7% of employment in Europe in 2013. The commercial property sector alone had a market value of some EUR 5 trillion and directly contributed EUR 285 billion to the European economy in 2011. It comprises around 2.5% of the total economy and employs over four million people – making CRE bigger than both Europe's automotive industry and its telecommunications sector.

Commercial property is where we work, shop and relax. It also includes rented housing, student housing for the young and assisted living accommodation for the old. It is also a vital enabler of economic activity, capable of supporting or constraining employment and growth. A healthy CRE investment market provides incalculable value to the economy by allowing businesses to rent premises flexibly according to their changing needs.

Around half of the EU's commercial property is leased by businesses. They often like the flexibility of renting and for many reasons may not want to allocate the capital and management time required by owner-occupation. That allows them to focus on their business and optimise their use of capital. By providing businesses with the physical infrastructure in which to carry out its activities, CRE is a critical enabler of economic growth and competitiveness generally.

As a capital intensive business generally involving relatively large and valuable assets, CRE is dependent on the ready availability of debt finance. The European CRE industry has historically sourced the significant majority of its debt finance from the banking sector. Indeed, during the last build-up phase of the market cycle the bulk of that finance was procured from a relatively small number of systemically important banking institutions.

When the CRE market and the global economy simultaneously entered a down phase, those institutions needed to boost their capital reserves and were reluctant or unable to provide loans to the sector, which contributed to the lack of new lending at the trough of the CRE cycle – just when that lending was most urgently needed. CRE lending by banks has since picked up again, but the industry's reliance on bank funding was very clearly exposed and the need for a more diversified and more resilient CRE finance market was clear.

This diversification has begun to take place, with non-bank institutions such as pension funds and insurance companies starting to provide CRE lending. Specialist CRE debt funds have also emerged, which are often willing to provide debt finance to CRE investors. We very much welcome these developments and hope that they will continue to progress. In our view the existence of CRE lenders with different business plans and investment horizons is conducive to both greater financial stability and a better availability of debt finance that is less linked to the CRE cycle, mitigating to a significant extent the damaging effects of CRE booms and busts.

The role of securitisation in Europe

CMBS attracted significant negative publicity during the latest CRE downturn. There were many instances of losses to investors as a result of the poor quality of underlying loan portfolios and of conflicts between different classes of bondholders.

However, it is important to note that CMBS losses did not primarily arise because securitisation is somehow inherently inappropriate for CRE loans, nor did they occur as a result of the CMBS structures in use at the time (although some could certainly have been better). Instead, the principal reason for losses on CMBS was a poor standard of CRE loan underwriting that had in some instances arguably been less than duly diligent. The fact that these CMBS investors faced losses simply reflected the wider CRE debt market.

In our view, CMBS can play an important part in a diversified and resilient CRE finance market. As noted in the Discussion Paper, securitisation (including CMBS) offers a tool for banks to diversify their funding sources and for non-bank institutions to gain access to investment exposure that might otherwise be out of their reach. We agree with these goals and support sound initiatives to help achieve them.

In order for CMBS to grow and serve as a useful source of CRE debt finance, though, its regulatory treatment must be proportionate. That has not been the case recently, however, for example with Solvency II requiring far higher capital requirements where insurers hold highly-rated CMBS than where they hold CRE directly. Such an approach seems designed to penalise CMBS, arguably because of its poor investment performance during the financial crisis, rather than because of the underlying investment characteristics of CMBS, which if designed correctly can be both secure and stable.

Comments on 'qualifying securitisations'

We welcome the Discussion Paper's principles-based approach to identifying potentially 'qualifying' securitisations. Further, we agree that such status should be attributed to securitisations which by *"their simplicity, structural robustness and transparency enable investors to model risk with confidence"*. CMBS should, in principle, be fully able to satisfy these criteria.

We also fully agree that qualifying status should not attempt to *"provide an opinion on credit or other risks, but make assessment of these risks more straightforward"*. Investors should be able to gauge the level of risk involved with a particular investment and make an informed decision whether it fits their investment strategy.

There are, however, some features of a qualifying securitisation identified in the Discussion Paper that do appear to take credit and other risks into account. In particular, paragraph 132 seems to suggest that refinancing risk cannot be accurately measured; as a result, loans that do not fully amortise cannot form part of a qualifying securitisation.

Such an approach would effectively preclude most CMBS from qualifying status, as CRE lending is very rarely fully amortising, as this can only happen where the underlying assets are subject to very long leases. That in turn would minimise the appeal of CMBS to investors, lenders and borrowers and prevent CMBS from playing an important role in a diverse CRE finance market. In any case, it is generally possible to assess refinancing risk, and CMBS should therefore not be denied qualifying status merely because the underlying loans do not fully amortise. Furthermore, certain features such as long tail-periods between loan and bond maturity can be incorporated into CMBS structures to further mitigate the risk of failed refinancing.

In summary, we believe CMBS could play an important role in the future of CRE lending. As CREFC, the British Property Federation and other industry bodies have argued, we agree that it would be unfortunate for the CRE industry and indeed for the economy as a whole if unnecessarily punitive regulatory measures constrain this.

We remain at your disposal should you wish to discuss these issues further.

INSTITUTIONAL INVESTMENT ADVISORS LIMITED

Comments on May 2014 Discussion Paper on:
"*The case for a better functioning securitisation market in the EU*"

Introduction

Our firm provides investment advisory and arrangement services to clients in the insurance, pension fund, banking and asset management sectors. Our main focus is on credit markets, which covers traditional fixed income, but also includes securitisation products, institutional loans and private debt.

Hence, our comments concern the issues confronting the actual and potential institutional investor base for European securitisation products.

Background

In the aftermath of the massive market sell-off following the Lehman Brothers collapse, we observed that in many asset classes there was a disconnect between the riskiness of the asset and the expected return on the asset. In our view this particularly applied to the situation prevailing in high quality European securitised products, where underlying credit performance remained strong, but price marks had fallen substantially below what, on any reasonable basis, could be deemed fair value.

As a result, we became strong advocates of securitised assets such as UK and Dutch Prime Residential Mortgaged Backed Securities. Prior to the credit crunch such assets traded on such tight spreads that the investor based consisted largely of leveraged buyers, such as banks and Structured Investment Vehicles. However, post the market sell-off we believed that such assets should be attractive to unleveraged so-called "real money" investors, such as insurance companies and pension funds.

Investor Issues

However, whilst there has been some take-up by this new investor base we have found that progress has been hampered by two main factors:

1. **"Brand damage"** – all securitised assets have been tainted by the dreadful performance of certain "failed" sub-classes, and in particular US Sub-Prime Mortgages. Even though the structure and performance of this sub-class is very different to that of many of the European securitised asset sub-classes, many CIOs and Investment Committees have been unwilling to even consider the investment case for this very reason.

2. **Regulation** – for those investor segments subject to capital adequacy rules, such as banks and insurers, new regulations introduced or proposed have been a major deterrent to investors. For example, the proposed Solvency II standard SCR calculation rules for securitised products are highly punitive and, for reasons we could discuss in more detail, materially miscalibrated in the light of the SII 1 in 200 confidence limit of a prospective distribution. In our view this has already led to a mis-allocation of resources, as insurers will be incentivised to invest in lower quality bonds rather than high quality securitised assets in order to achieve a lower regulatory capital requirement. We have also seen little evidence of insurers being able to incorporate securitised assets into their internal models, so in our view internal models are not offering a practical solution to the mis-specification of the proposed standard capital charges.

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Conclusions & Solutions

We believe that the European securitisation market will only flourish if it establishes a strong and sustainable investor base. Pre-crisis the investor base was too dominated by the leveraged players which introduced an unhealthy dynamic in the marketplace and meant that the market disruption was much more pronounced than it would have been had real money investors been a much bigger proportion of the investor base.
Disruption was more muted in the largely fixed rate corporate bond market, where insurance companies and pension funds are the dominant investors: they are less prone to sell as a result of a technical weakening in bond prices than leveraged players who are, by that leverage, much more sensitive to the mark-to-market value of their holdings.

If the authorities took action in the following areas then we believe that this would be extremely supportive of the development of the investor base:

1. **Objective assessments of the performance of securitised assets –** bodies such as the Bank of England, ECB and BIS should undertake their own studies of the various securitisation sub-classes and produce their evaluation of the structures and performance.
   This has the best chance of overcoming the "brand damage" issue which has tainted all securitised assets, as studies from other parties (e.g. rating agencies, consultants) have a tendency to be treated with suspicion by investors due to conflict of interest concerns. The lack of such studies has left investors to assume that the authorities also have a negative view on securisation assets, so it would be good to correct this mis-interpretation.

2. **Balanced regulatory treatment of securitised assets –**this builds on the first point above, because it is essential that the regulatory treatment is (a) reflective of the prospective risk and (b) takes account of what institutions are permitted to invest in, such that only some of the historical data is in the least relevant. As noted above, European regulators' capital adequacy proposals for securitised products do not provide a level playing field for securitised assets.
   For example, it is a nonsense that under the Solvency II proposals Covered Bonds are weighted much more favourably than similarly rated RMBS issues. In support of this we would point to the superior performance of the Co-operative Bank's triple-A rated bankruptcy remote RMBS issues during its financial crisis in 2013, compared with their Covered Bond issue. Whilst the RMBS ratings were reconfirmed at Aaa the Covered Bond was downgraded from Aaa to Baa3, and whilst the secondary prices of the RMBS issues remained firm, the price of the Covered Bond fell by over 10 points.
   Without a fair regulatory treatment for securitised assets we believe that the European securisation markets will remain sub-optimal. Action on resolving this issue cannot be deferred if the authorities want to re-energise financing flows to the real economy from the European securitisation marketplace.

Institutional Investment Advisors Limited **02 July 2014**

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Position Paper

Insurance Europe response to ECB and Bank of England discussion paper on securitisations

Our reference:	ECO-INV-14-104	Date:	4 July 2014
Referring to:	ECB and BoE discussion paper: *The case for a better functioning securitisation market in the European Union*		
Related documents:			
Contact person:	Cristina Mihai, Policy Advisor, Investments Olav Jones, Director, Economics and Finance	E-mail:	mihai@insuranceeurope.eu jones@insuranceeurope.eu
Pages:	8	Transparency Register ID no.:	33213703459-54

Key Positions

- Insurance Europe supports the idea that diversification of lending in the economy is beneficial for financial stability.
- The discussion paper appropriately identifies insurers as a potential investor in securitisations.
- The approach of separately identifying "good quality" (ie "qualifying") securitisations is needed and welcome. However, in the Solvency II framework the definition of the high quality "type A" class is too restrictive and the proposed capital charges remain unnecessarily punitive.
- Insurance Europe believes that any approach for defining "good quality" securitisations should be principle-based.
- The following three main pillars should be used as a guide to apply the principles around "good quality" securitisations:
    1. A higher selectivity of underlying pool of assets, which should be homogenous, granular and with measurable risk profiles
    2. Simplified and standardised securitisation structures
    3. Further transparency and disclosure obligations
- While the development of a "qualifying securitisation" framework is necessary and welcome, a more liquid secondary market is desirable; secondary market liquidity would limit (extreme) cases of market-to-market (balance sheet) volatility and would thus increase the attractiveness of securitisations.

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General Comments

Insurance Europe welcomes the ECB and Bank of England discussion paper on securitisations and the opportunity to contribute to it.

Reviving long-term financing remains one of the most pressing policy issues in Europe. As the largest European institutional investor, holding €8.6tn of assets under management at the end of 2013, insurers are well positioned to support long-term financing to the real economy, as their long-term liabilities enable them to hold long-term assets.

The availability of assets is crucial to the significant investment role that insurers play in the economy. Insurers need access to a wide range of assets that enable them to match their liability needs and that allow for portfolio diversification. As noted in the discussion paper, ensuring that securitisations can be part of insurers' asset pool has a range of benefits for policyholders but also for the wider economy.

The paper correctly identifies high Solvency II capital charges for securitisations as a barrier to a well-functioning securitisation market in the EU. Despite some improvements following EIOPA's proposals and the Commission's drafting changes to the Solvency II Delegated Acts, capital charges for securitisations remain unnecessarily high and will continue to restrict the ability of insurers to invest in this asset class.

While we welcome that Solvency II will now recognise that high quality securitisations can and should be identified, the definition of the high quality "Type A" is unnecessarily restrictive and the calibrations proposed are still far too high. For example, a AA 5-year securitisation will still have a capital charge of over 21%. This should be compared to the total actual accumulative default rate during the crisis (2007 to 2013) of only 0.14%. This discrepancy arises because in the current Solvency II draft implementing measures the capital charges for the credit risk posed by securitisations have been calibrated based on the worst case spread movements instead of worst case defaults. However, insurers with a long-term nature of liabilities can avoid being forced sellers during market volatility and are therefore exposed to default risk rather than risk of losses due temporary price changes due to spread movements.

Detailed comments on various aspects raised in the discussion paper

- **Insurance Europe supports the idea that diversification of lending in the economy is beneficial for financial stability and insurers as investors can play an important role in the stability of financial markets**

  Insurers' buying and selling of assets is inclined to be counter-cyclical. Even in periods of market stress with significant market volatility, insurers have a stable flow of premiums which, together with predictable liability outflows, can enable them to hold or even buy assets that are temporarily undervalued during a downturn and to sell or avoid assets that are temporarily overvalued during a boom.

- **The discussion paper appropriately identifies insurers as a potential investor in securitisations**

  Alongside other assets, securitisations can provide suitable and attractive investment profiles that satisfy the asset allocation objectives of insurers.

  A survey run on 13 large European insurance companies, managing €3.4tn of assets at the end of 2012, indicated that insurers' exposure on securitisations is larger than €50bn. This however represents less than 4% of total outstanding European securitisations and less than 2% in terms of average weight in the asset portfolio.

While the survey indicated that all respondents would like to increase their allocation to securitisations, a number of barriers and disincentives were also mentioned by respondents to the survey. The vast majority of respondents indicated that Solvency II capital charges applied to securitisations represent the biggest investment barrier. Some respondents noted that, besides Solvency II capital charges, a number of market related barriers emerge, namely regarding the lack of deal flow, the low liquidity and the lack of transparency of these assets. Such concerns are appropriately identified in the ECB and BoE discussion paper.

- **Securitisations were a key discussion point in the long-term investment debate launched by the European Commission in 2013**

The insurance industry welcomed the European Commission request to EIOPA to review the design and calibration of solvency requirements for long-term assets in order to avoid unnecessary disincentives for long-term investment. As the discussion paper mentions this resulted in an EIOPA's technical report, published in December 2013. The conclusions of the report were also reflected in the Solvency II draft Delegated Acts.

- **Even after recent changes in the Solvency II draft Delegated Acts, a number of concerns remain**

The approach for charging securitisations in Solvency II is to split them into 2 classes (ie high quality "type A" and lower quality "type B"). While the insurance industry welcomed recognition that high quality securitisations can and should be separately identified, the definition of the high quality "Type A" is restrictive and the calibrations proposed are too high. This will restrict the ability of this asset class to be viable for insurance companies.

For example, a AA 5-year securitisation will still have a capital charge of over 21%[1]. This is an improvement of the original calibration which would have been an 80% capital charge[2]. However, as noted above, these excessive capital charges for credit risk arise because the calibrations are based on market value changes and include the most extreme spread movements in securitisations during the crisis period. We believe that, for insurers with long-term liabilities, the real exposure is to defaults and worst case default calibrations would result in more appropriate capital charges. EIOPA's study did not even consider whether default based calibrations were a more appropriate basis. The insurance industry recognises that further analysis and time may be needed before a default based approach is adopted for calibrations and therefore it recommended for the current Solvency II Delegated Acts a pragmatic and conservative solution of basing capital charges for high quality securitisations on those used for corporate bonds. This would have resulted in 5-year AA high quality securitisations having a capital charge of 5.5%.

- **The criteria for defining "high quality" securitisations should be principle-based**

While Insurance Europe agrees that a split between "high" and "low quality" securitisations is needed and welcome, the approach should be principle-based. In the Solvency II discussions the insurance industry raised a number of concerns regarding the very prescriptive criteria used.

[1] Based on latest Solvency II draft implementing measures of March 2014

[2] Based on Solvency II draft implementing measures of October 2011

For example, in the current draft Delegated Acts, junior tranches of securitisations are considered to be, by definition, "low" quality (ie in the "more risky" basket, "type B") only because of their junior status. Insurers are however investing in junior tranches (because of eg their longer maturities) and a currently foreseen charge of more than 12% per year of duration3 would represent a strong disincentive to invest. Insurance Europe believes that considering all junior tranches as "more risky" is a quite rough estimation of risk and recommended excluding high quality non-senior securitisation from "type B" since high quality non-senior securitisation showed much better performance than non-high quality securitisation both from a credit and spread perspective since the financial crisis. Switching from "type B" to "type A" the high quality ABS mezzanine would make sense as there is less and less evidence of significant deviation of spread volatility performance between high quality ABS mezzanine tranches and high quality ABS senior tranches.

Insurance Europe therefore supports the view of the ECB and BoE on the fact that a quality designation should apply to all tranches of securitisations.

- **Insurance Europe believes that the principles set in Box 3 are broadly sensible and in line with the objective of promoting securitisations amenable to risk assessment**

The call for more standardisation is key: securitisation markets would strongly benefit from more harmonised standards across the EU, and also from improved data availability. This would ultimately make the asset class more attractive for institutional investors, including insurers.

Insurance Europe believes that the following three main pillars should be used as a guide to apply the principles described in Box 3. This would help to address the impediments identified in the discussion paper and to re-build investors' trust and interest in the securitisations market:

1. A higher selectivity of underlying pool of assets, which should be homogenous, granular and with measurable risk profiles
2. Simplified and standardised securitisation structures
3. Further transparency and disclosure obligations

Detailed examples on how to elaborate each of the three pillars are provided in the **Appendix.**

- **Once a framework of "qualifying securitisation" is defined, it should be used and applied across industries, including as part of the Solvency II approach for determining capital requirements for investments in securitisations.**

Insurance Europe believes that ccompliance with such principles for "qualifying securitisations" should be checked and assessed by an independent, private or public body and could be rewarded by the granting of a label (similar to the PCS label), which could become compulsory and delivered before any new issuance.

- **While the development of a "qualifying securitisation" framework is a necessary and important step for a sustainable revival of the European securitisation market, other steps would also be important for investors. For example, as appropriately noted in the discussion paper, a more liquid secondary market would act to limit cases of mark-to-market (balance sheet) volatility.**

[3] Based on latest draft Delegated Acts

As noted in the discussion paper, it's likely that "qualifying securitisations" will benefit from better secondary market liquidity thanks to standardisation of the structures and increased transparency, both in terms of loan data disclosure and accurate modelling tools availability. Nevertheless, it is important to thinks of additional mechanisms allowing to limit the price volatility risk by, for example:

- ensuring the implementation of an effective and regular market making
- considering the implementation of specific solutions in case of liquidity crisis
- introduction of the idea of a "last recourse buyer" via specific programs (such as the asset purchase program implemented in the US or the program on European Covered Bond during the financial crisis)

APPENDIX

Insurance Europe believes that the following three main pillars should be used as a guide to apply the principles described in Box 3. This would help to address the impediments identified in the discussion paper and to re-build investors' trust and interest in the securitisations market:

1. A higher selectivity of underlying pool of assets, which should be homogenous, granular and with measurable risk profiles
2. Simplified and standardised securitisation structures
3. Further transparency and disclosure obligations

More details on the implementation of these pillars are provided below.

1 A higher selectivity of underlying pools of assets, which should be:

- **homogenous and consistently originated in the ordinary course of the originator's business**
  - The underlying pools of assets have to include one single type of debt / sub-asset class such as SMEs loans, prime residential mortgage loan, auto loan, etc.

- **granular**
  - The capacity to assess the risk and reward of a securitisation transaction in a consistent and predictable manner relies on the ability to perform statistical analysis to determine the behaviour of the assets under various scenarios. Any non-granular pool will require performing a detailed analysis of every receivable belonging to the pool of assets; while possible, the assessment does not correspond to the principles of transparency in securitisations.

- **with a measurable risk profile**
  - The analysis of risk profile of the underlying pool of receivables will be based on historical performance data of similar receivables (eg debts with similar features and originated under the same criteria).
  - **Historical performance data must be available for a long-enough period of time (ie to cover multiple economic cycles.** Generally, this requires a minimum 5-year history, with the ability to cover 10 years for assets with long cycles. If not available, credit data or information from credit registers should be made available to investors in an open way and with sufficient details. This is a necessary condition for the future development of eg securitisation of SME loans where the level of historical performance is often lacking, inconsistent or incomplete.
  - **Historical performance data provided must be relevant enough to determine the risk profile of the securitised pool** by**:**
    - including the key risk factors of the pool of receivables from which the historical performance data is extracted (such as LTV, DTI, delinquencies, prepayment, etc).
    - reflecting specificities of the originators' underwriting criteria and process, as well as their development in time. The origination criteria and process have a significant and direct impact on the performances of the securitised receivables. Moreover, any substantial change of the origination criteria should be identified and disclosed to investors to allow them to determine whether the historical data is still relevant to assess the risk profile of the securitised pool.
  - In the case of pools of assets with limited historical data, it would be advisable to set up databases to start collection of information (eg similar to the ECB initiative on databases)
    From an investor perspective, it is key to obtain confirmation that securitised transactions comply with these criteria of homogeneity, granularity and measurable risk profile. It is also likely that only certain types of pools or sub-asset classes will comply with these criteria; this

will eventually incentivise the development of a securitisation market based on assets which are transparent and with measurable risk profiles.

2 Simplified and standardised securitisation structures

Simplification and standardisation of securitisation structures are necessary and will incentivise liquidity of the secondary market for securitised products. The following areas could be explored:

- **Definition of standard structures by asset class including, but not limited to:**
  - a standardised "waterfall" of payments
  - a standardised credit enhancement mechanism
  - a simplified note structure
  - predefined replenishment criteria for only short dated assets
  - standard representations & warranties on the assets made by the originator per jurisdiction.

- **Standardisation of definitions of key concepts and risk factors**
  - Today, in Europe, there is no homogeneous definition of the main factors characterising the risk profile of securitised assets. This often leads to significant difficulties in performing transactions' comparison. For example, there exist differences across jurisdictions in the definition of defaulted assets, delinquencies or loan to value.
  - The AQR currently in progress in the banking industry could be a good opportunity to begin this difficult but necessary work.

- **Development of modelling and performance measurement tools available to investors**
  - On the basis of more standardised structures, it becomes possible to provide additional and standardised information for investors on the risk profile of the notes issued by the securitisation under various risk scenarios.
  - The arranger and/or trustee should provide investors with the results of this cash flow modelling under various risk scenarios at both issuance date and during the life of the transaction (to assess the evolution of the risk/reward profile of the notes). This will enable investors to compare outcomes of these cash flow scenarios with the ones from other transactions and also with outcomes of their own cash flow modelling.

3 Further transparency and disclosure obligations

Over the past years the European securitisation market has benefited from improvements in terms of information transparency thanks to the requirement by both ECB and BoE for loan-by-loan data as part of their collateral eligibility criteria and the launch of market-led securitisation label initiatives (ie the PCS). Further improvements in not only loan data transparency, but also in information disclosure relative to the securitisation structures and participants would enrich investors' assessment process. The following areas are examples of information that would be useful for investors to assess securitisations and would enable them to monitor transactions in a consistent and predictable manner:

- For any new transaction investors should have access to:
  - detailed characteristics of the underlying pool of assets at both loan-by-loan and aggregate level
  - accurate and detailed cash flow models either directly from the issuer or through external providers. Having access to accurate and detailed cash flow models is key and requires the disclosure of elements that are today generally not publicly available such as : fees due by the securitisation structure to the different participants and details of structural features like swaps or liquidity facilities.

- During the life of the transaction investors should have information on the performance of the notes issued by the securitisation transaction and on the underlying pool of assets.
    - Detailed reporting on transactions' performance are today provided by the securitisation trustees and by rating agencies. It is important to strengthen these reporting aspects by ensuring minimum standards of disclosure.

- Transparency on the role played by all parties involved in the securitisation structure is important
    - This could include description of roles and responsibilities of the originator and seller of the assets, servicer, swap counterparties, credit enhancement providers, guarantors, trustees and management companies, rating agencies (important to get more info of the rating agency selection process)

- Identification of potential conflicts of interests and implementation of mitigants should be required
    - Alignment of interest between the originator/seller of the assets and investors could be achieved by applying retention principles throughout the life of the deal, without hedging possibility (as already implemented or under discussions in a number of jurisdictions)
    - In Europe, where the responsibility of checking the retention requirement lies upon investors, the disclosure of this information by the sellers during the life of the transactions in a consistent, transparent and detailed way is key for investors. Some investors may find such responsibility falling on them too heavy and decide not to invest in securitisation.

- Disclosure of particular positions of specific investors in the transaction (such as an originator investing in the capital structure at equity level) would represent useful information for investors

- Alignment of interests of the different parties via fee structures and payment mechanisms should be promoted

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4th July 2014

Dear Sirs

ECB/Bank of England Discussion Paper– The case for a better functioning securitisation market in the European Union, May 2014 (the "DP").

Introduction

The Loan Market Association ("**LMA**").welcomes the opportunity to give feedback to the European Central Bank and the Bank of England (the "Central Banks") on the issues raised in the DP, and thank both Central Banks for their continued engagement with the CLO market.

Whilst the discussion below attempts to answer many of the questions raised in the DP, it has not been possible to give a complete response to some questions in the time available. We have however aimed to highlight the main issues for managed CLOs as opposed to other securitisations, in the hope that we can engage in productive dialogue with the Central Banks around that asset class.

The LMA would be pleased to provide additional information on the CLO market following the closure of this consultation, and would also be keen to meet in the coming months to assist the Central Banks on a bilateral basis with any questions pertaining to the CLO market.

Whilst CLOs returned to Europe during 2013, with new issuance totalling €7.4 billion by the end of the year, some challenging obstacles remain for the market in the medium term. Risk retention rules continue to restrict the ability of managers, who are typically thinly capitalised, to issue significant numbers of transactions. On the asset side, leveraged loan supply has been significantly down on pre-crisis volume, reaching €67.6 billion across leveraged buy-out and non-leveraged buy-out volumes by the end of 2013 compared to €165.5 billion by the end of 2007[1]. Furthermore, an increasing proportion of pre-crisis CLOs have reached the end of their re-investment period. At the end of 2013 there were approximately €78-€79 billion of CLOs currently outstanding in Europe of which there were €52.7 billion of CLO transactions in their amortisation period at the beginning of 2014, with another €15.5 billion (33 deals) of CLO 1.0s expected to enter amortisation by the end of 2014[2]. The vast majority of present European CLO investment capacity is rolling off and is not being replaced in sufficient volume by the new issue market owing in part to regulatory constraints arising from risk retention requirements.

Furthermore, the figure of €7.4 billion for European CLOs is merely a fraction of U.S. issuance over the equivalent time – which totalled $81.8 billion[3]. In our view, the speed of recovery in the U.S.

1 Source - S&P LCD

2 Source – S&P LCD referencing Deutsche Bank.

3 Source – S&P LCD

CLO market versus that in Europe is at least in part due to the impact of risk retention on EU CLO managers.

We think it is helpful in reading this paper to remember that "open market" managed CLO portfolios have an uneasy fit into the definition of securitisation used in CRR and other regulations and have encountered significant problems in complying as a result. One result of this is to restrict the number of CLO managers who can bring deals to market, thereby reducing investor choice. Additionally, even larger managers are restricted as to the number of deals they can complete, due to the size of the retention requirement they have to hold as sponsor.

CLOs differ from most static-pool securitisations in some fundamental ways. Below is a brief description of the timeline of a CLO:

A CLO portfolio will not usually be complete on closing of the securitisation. During the warehousing period, prior to issue of bonds by the CLO vehicle, the CLO vehicle accumulates assets from the open loan market, and these assets must meet the eligibility criteria.

Once these assets reach a critical mass, the CLO vehicle securitises them by issuing notes to investors in the market. Following note issuance, the manager continues to purchase assets on behalf of the CLO vehicle, using the proceeds from the notes issuance, until the target value of the portfolio is reached. This "ramp-up" period may continue for up to six months after closing.

There follows a reinvestment period (typically four to five years after closing), during which the manager i) can trade assets up to a certain percentage (usually 20-30% annually), and any assets which are "credit improved" "credit impaired" or defaulted provided the new assets meet the eligibility criteria and certain tests (described in our response to Question 7 below) are met, and ii) reinvest principal proceeds from the assets in buying new assets.

After the reinvestment period finishes, i) unscheduled principal payments received from the underlying assets and ii) sale proceeds from "credit improved" and "credit impaired" assets may also be reinvested by the manager (to the extent they are not required to pay items in the principal priority of payments such as any interest shortfalls on senior notes). Other principal receipts after the reinvestment period are used to redeem the notes sequentially, and many deals also have a clean-up call once the portfolio falls to 15-20% of its original target size.

Such "managed" CLOs provide banks, pension funds, insurance companies and other institutional investors with access to investment in the leveraged loan market but with robust portfolio quality requirements, structural protections and credit enhancement built in to the transaction to reduce risk. These features are outlined in Questions 6 and 7 below. Typically, CLO notes are not designed to amortise earlier than 4-5 years, hence are longer-term than some securitisations, which makes them attractive for investors who need to match their investment to their longer-term liabilities. CLOs do not rely on refinancing as the portfolio is comprised of assets in which there is an open market. Principal is paid to noteholders as assets amortise or are sold (to the extent not reinvested) following the end of the reinvestment period.

More detail as to the composition of the portfolio and the structural features of CLOs is given in our answers to the specific questions below.

List of Questions

1. **DO RESPONDENTS AGREE WITH THE BENEFITS OF A WELL-FUNCTIONING SECURITISATION MARKET AS OUTLINED IN SECTION 2?**

   We largely agree with the benefits outlines in Section 2 of the DP. With respect to managed CLOs, we would add some further comments.

   As CRD IV comes into effect, non-bank institutional lending will be necessary in order to inject much needed credit into the loan markets. The continuing development of the CLO market is, in the view of the LMA and the Working Group, a key component of this initiative.

As the well-publicised €122 billion "refinancing wall" approaches, there is a significant risk that many European corporate borrowers will be unable to refinance their existing debt via traditional methods, such as through relationship banks and the syndicated loan market. At the same time as there is a peak in refinancing, the European loan market faces reduced lending capacity. Primarily, banks, which provided over 60% of pre-crisis credit, are less able to lend under revised regulatory capital regimes - a trend likely to continue as the leverage ratio is introduced. CLO vehicles provide a crucial means of bank de-leveraging. The pre-crisis CLO universe is reaching the end of its permitted reinvestment capability, whilst new CLO issuance has been low due to European-specific regulatory change. The lower lending capacity will be further impacted by the regulatory capital treatment of European credit institutions following the implementation of CRD IV, which is likely to make lending to the sub-investment grade sector less attractive for European credit institutions.

Whilst the high yield bond market or the IPO market can fill a portion of this refinancing gap, many borrowers will be unable to access these markets for a number of reasons, such as their enterprise value, size or credit profile. Therefore, as European corporate refinancing requirements substantially increase, there is a concurrent risk of refinancing options and investment capacity substantially diminishing. The U.S. CLO market has experienced a significant revival over the past two years whilst in Europe the risk retention rules in particular have created a number of difficulties for the CLO market.

CLOs do not re-securitise assets. The underlying loans in a CLO portfolio support private and public companies across Europe, which in turn create employment for millions of people throughout Europe.

2. **DO RESPONDENTS AGREE WITH THE IMPEDIMENTS TO AND ECONOMIC CONCERNS OF INVESTORS THAT HAVE BEEN IDENTIFIED? DO RESPONDENTS THINK THAT THERE ARE ANY ADDITIONAL IMPEDIMENTS TO INVESTORS, AND IF SO, WHAT ARE THEY? DO RESPONDENTS AGREE THAT THE INFRASTRUCTURE CONCERNS RAISED ABOVE AFFECT THE ECONOMICS OF SECURITISATION?**

2.1 *Solvency II and the EIOPA technical report*

The proposed capital treatment of CLOs in the Solvency II regime give us significant cause for concern. In September 2012, the European Commission requested EIOPA to review the calibration of capital requirements for investment in certain classes of long-term finance which provide management of long-term risk for insurers. In December 2013, EIOPA produced that report, entitled "Technical Report on Standard Formula Design and Calibration for Certain Long-Term Investments" (The **"2013 Report"**). In the 2013 Report, the classes of securitisation transaction which qualify as "Type A" and therefore attract lower capital charges expressly exclude CLOs other than SME CLOs. The criteria for qualification as "Type A" securitisation in the 2013 Report have now been included in Part I of EIOPA's "Technical Specification for the Preparatory Phase" of Solvency II based on the working documents of the Level II delegated Acts to be published later this year, which was published on 30 April (the **"Technical Specifications"**). Our belief is that if CLOs were to remain in the "Type B" category proposed by EIOPA, there is a real risk that insurers required to use the Solvency II Standard formula may pull out of investing in CLOs altogether as an asset-class.

We believe that the categorisation of CLOs as "Type B" by EIOPA is based i) on a misunderstanding of the nature of the risk-mitigating structural features of managed CLO transactions and ii) a focus on the widening spreads which resulted from rating downgrades of CLO tranches during the financial crisis - which downgrades were not borne out by default rates, and have since been largely reversed.

The 2013 Report states (at page 121) "The underlying of CLOs and CDOs is typically speculative-grade corporate debt". This is only part of the picture. The vast majority of CLO "2.0" portfolios consist of 90% or more *senior secured* bonds or loans to sub-investment-grade corporates, and a typical CLO portfolio will contain no ABS or synthetic exposures. Whilst the category of assets securitised by managed CLOs is leveraged loans, overwhelmingly it is only the senior secured portion of the leveraged loan which goes into the CLO. There is typically a minimum rating requirement for the underlying assets going into the portfolio. The portfolios are actively managed in accordance with strict portfolio tests. Furthermore, mark to market haircuts are applied to portfolio assets in breach of CCC excess requirements and to defaulted obligations which can result in the failure of the CLO to meet coverage tests thereby triggering cash flow sweeps in the interest priority of payments to repay note-holders in order of seniority. When coverage tests are triggered, all cash is diverted to repay investors, including cash which would have paid the majority of the CLO manager's fees. The transactions also benefit from credit enhancement provided by subordinated notes, to ensure that the rated notes are supported to a level justifying their rating.

We also believe that EIOPA's focus on rating downgrades as the main indicator of quality of an asset class is inappropriate. The 2013 report places CLOs in "Type B" on the basis that 72.3% of leveraged loan CLOs were downgraded between mid-2007 and end of 2012. We would dispute this figure as representative of the performance of European CLO tranches.

Firstly, a significant amount of downgrades were a result of a change in the default models in rating criteria, and not actual default rates. S&P had updated their criteria in September 2009, and acknowledged that "Virtually all of the "AAA" downgrades resulted predominantly from the application of the updated criteria, rather than transaction performance."[4]

Moody's updated their criteria on 4th February 2009, also changing their default probability model[5], and reviewed CLO tranches against the new criteria. Of the 395 Aaa-rated CLO tranches in Europe at the start of 2009, 47% retained their rating, while 53% were downgraded.[6]

Secondly, CLO transactions continued to perform well in relation to other asset classes following the downgrades to end of 2012, and S&P and Moody's both upgraded a significant proportion of tranches in CLO transactions as a result. As stated in the S&P research paper relied upon by EIOPA[7], S&P subsequently upgraded a number of tranches in CLOs due to the operation of "structural deleveraging" (explained below). In November 2011 Moody's announced that 81% of the European CLO tranches originally rated Aaa were back to their original ratings, as a result of revised rating criteria in June 2011 together with improved par coverage and credit quality[8]. The downgrade figure of 72.3% relied upon by EIOPA is therefore not representative either of default rates in CLOs, or in fact downgrades in existing CLO tranches in Europe.

Furthermore, CLOs should be able to fulfil the structural requirements of "Type A" securitisations proposed by EIOPA. Annex I to this letter contains our comments on compliance by CLOs with the various EIOPA requirements contained in the Technical Specifications.

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4 "Summary of Rating Actions on European CLOs Following Corporate CDO Criteria Update" - S&P Ratings Direct, 15 June 2010.

5 "Moody's updates Key Assumptions for rating CLOs" - Moody's Global Credit Research 4 February 2009.

6 "Moody's Completes European CLO rating review" - Moody's Global Credit research 21 January 2010.

7 Pre-Crisis European Structured Finance Still Exhibits Few Defaults" Standard and Poors April 2013", page 6

8 See "Moody's completes European CLO rating sweep, upgrades 969 tranches" - Moody's Global Credit Research, 22 Nov 2011.

With respect to the content of the portfolio- whilst our view is that historical default rates paint a much better picture of CLO asset performance than the 2013 Report would seem to suggest, our proposal in our response to question 9 below contains portfolio requirements aimed at enhancing the credit quality of the portfolio – something which is happening anyway in more recent CLOs.

2.2 *Risk Retention*

The European risk retention requirements in the Capital Requirements Regulation (**"CRR"**) and the Alternative Investment Fund Managers Directive (**"AIFMD"**) have proved a significant challenge for investors in the CLO market. Despite the recommendations of IOSCO[9] that an exemption from retention be considered for managed CLOs, the "one-size fits all" nature of the retention requirement was imposed and has presented significant difficulty for CLO structures. As managers have struggled to fund and hold the retention and the related capital, so investors have struggled with the requisite assurance that the transaction is compliant if any mechanism is used other than simply the manager holding and funding the retention from its own balance sheet (see below).

Similar requirements are due to apply to insurer investors once Solvency II comes into force, and to UCITS funds once the implementing regulations are made under the new UCITS Directive.

Apart from the structuring of the retention itself at the outset of the transaction, there are ongoing difficulties with the retention rules which potentially affect returns to investors and investors' ability to remove a failing manager.

2.3 *Change in sponsor or originator*

The retention rules as yet contain no clarification as to how compliance can be achieved in circumstances where the CLO manager holds the retention and is subsequently removed. CLO documentation allows a CLO manager to resign or be removed under certain circumstances, but in such circumstances, the CLO manager would no longer be a "sponsor" or an "originator" once it is no longer managing the CLO. In addition, requiring the transfer of the retention to the replacement CLO manager may in fact make it difficult for investors to find a replacement CLO manager and any removal of a CLO manager is only effective if a replacement CLO manager is appointed. This is an example of where the rules which are clearly intended to protect the interests of investors may actually serve to prejudice them.

2.4 *Inability to reinvest trading gains when holding first loss*

As the rule requires retention by way of a first loss position to be measured by reference to the nominal value of the underlying assets, CLO managers who realise trading gains are unable to reinvest them to buy assets with a greater par value, as this would mean having to restructure the transaction so that they hold a higher notional amount as a first loss position. Instead, trading gains are having to be paid out to noteholders rather than reinvested. It would be in the interests of noteholders to allow the CLO manager to choose to reinvest receipts from trading gains, and with this in mind we would suggest that the measure of the retained interest be consistent – either to reflect a percentage of the amount invested in the assets on day one of the deal, or a percentage of the tranches sold to investors.

2.5 *Basel II and new Basel Proposals for the securitisation framework.*

9 "Global Developments in Securitisation Regulation" – IOSCO, 16th November 2012, page 48

We agree with the remarks made in the DP that the BCBS proposals fail to reflect the true position with regard to losses incurred in European securitisations.

At this stage (and as we agree with the remarks made in the DP on this subject) we do not propose to specifically analyse here the treatment proposed for securitisation exposures which are CLOs under the Basel Committee on Banking Supervision's (**"BCBS"**) second consultation "Revisions to the Securitisation Framework" published in December 2013. However we note that the BCBS has rejected strict capital neutrality as a premise for the application of risk weights to the tranches of a securitisation when compared with the capital treatment of the underlying exposures. There is also a risk weight floor of 15% for senior AAA positions in securitisations, whereas under the current framework these can achieve a risk weight of 7%. The risk weight cap and the limited "look-through" approach for senior securitisation exposures mitigates this to some extent, but the capital neutrality of the Basel II framework has been removed.

We believe that capital neutrality should be a basic premise for the regulatory capital treatment of securitisation exposures. The capital charges applied to a pool of exposures prior to securitisation should be broadly equal to the total capital charge applied to the tranches of the securitisation, to reflect the unchanged economic risk across the pool. With respect to senior tranches, a cap on the capital charge of a senior tranche to the level of the look-through approach in Basel II should be preserved, to reflect the benefit of the credit enhancement in the securitised tranche.

In the case of a managed CLO, the portfolio is managed to ensure compliance with strict debt coverage tests and collateral quality tests which meet rating agency requirements. This added layer of protection is not available to direct investors in the loan portfolio, and the capital charge should reflect this. Furthermore, whilst the BCBS has as yet not made a distinction in the December 2013 paper between "Type A" and "Type B" securitisation, any proposal to ascribe higher capital charges to banks investing in CLOs would be in our view detrimental, and could pose a real risk that bank investors would pull out of the CLO market, leaving the universe of CLO investors insufficient to keep CLO issuance economically viable.

3. **DO RESPONDENTS AGREE WITH THE IMPEDIMENTS TO AND ECONOMIC CONCERNS OF ISSUERS THAT HAVE BEEN IDENTIFIED? DO RESPONDENTS AGREE THAT THE INFRASTRUCTURE CONCERNS RAISED ABOVE AFFECT THE ECONOMICS OF SECURITISATION?**

The main economic concerns of issuers of CLOs (and in this context we equate CLO managers with issuers) centre on the impact of risk retention rules. These fall largely into two areas – structuring the retention itself, and dealing with funding and cost of capital.

3.1 *Risk Retention*

The main problem for CLO managers in complying with the retention requirement is funding the retention and the related capital requirement. Whilst banks in the normal course take credit risk on the portfolios they originate prior to securitisation, CLO managers do not. Banks hold capital against that credit risk before any securitisation, and by securitising, hope to achieve significant risk transfer (SRT) and reduce the capital they are required to hold. Even if they fail to achieve SRT, the capital charge to a bank is capped at the charge applicable to the original portfolio.

Contrast a CLO manager – the CRR applies a less onerous own funds requirement to an investment manager which doesn't deal as principal or underwrite financial instruments, recognising that these managers do not usually take credit risk. Managers can, and do, use an own funds calculation equal to a portion of fixed overheads where they do not take significant credit risk. In complying with the retention requirement, managers are effectively being penalised by having to hold credit risk, and the corresponding capital, following a securitisation, where prior to it they held none. Banks meanwhile will never have to increase their capital charge on a portfolio they securitise, and are reducing their credit exposure by securitising, not increasing it. This seems incongruous, when the aim of the retention requirements is to realign the interests of those who repackage risk with those of investors.

Our view is that there are clear structural and economic differences between independently-managed CLOs and balance-sheet securitisations in which the originate to distribute model could exist. As a result, retention is not the most suitable method of alignment of interest for managed CLO transactions.

CLO managers are not transferring credit exposures from their balance sheets, unlike a typical securitisation. CLO managers are selecting and trading assets in the liquid markets, to create an investment return for third party clients, much as other portfolio managers do in the same asset classes globally. MiFID and AIFMD both address the conflicts of interest which Article 405 was intended to address. These directives require CLO managers to act honestly, fairly and professionally and in the best interests of their clients, and to manage conflicts of interest so as to avoid damage to clients' interests. CLO managers in the United States are subject to similar requirements under the Investment Advisor's Act. Accordingly, firms must comply with these obligations when managing the portfolios of CLOs and other funds.

Furthermore, CLO managers are already incentivised to act in the best interest of the CLO noteholders through the structure of their fees. CLO managers have always had an alignment of interest due to the unique structural features of these transactions. This was the case pre-crisis and continues to be the case now. Only a small fee (typically 15 basis points) is paid to the manager prior to the payments of interest to noteholders, and this fee covers only a portion of the manager's operating overheads. There is also a subordinated fee (typically 35 basis points) to cover any remaining running expenses of the manager, but this fee is only payable following the payment of all interest due to the rated noteholders. In the event there is under-performance by the manager these fees are "switched off" and amounts are instead used to repay the noteholders in accordance with their ranking in the priority of payments. Lastly, CLO managers are usually entitled to an incentive fee which is only paid if the interest due on interest-bearing notes has been paid and the unrated subordinated debt has received a pre-agreed rate of return. This compensation structure ensures that the interests of CLO managers are appropriately aligned with those of CLO investors throughout the life of the transaction.

It should be noted that asset managers managing the same underlying assets in other types of investment vehicle, including those with leverage but which are not securitisations, are not required to hold a retention.

As a result in the context of the EBA's continuing workstream to review the CRR retention requirement, we have argued for an exemption for CLOs, as per the IOSCO recommendation. In the event that CLOs cannot be exempted, we would advocate a smaller retention requirement for sponsors such as CLO managers who are not originating the portfolio being securitised, in keeping with the manager's MiFID permissions (or third country equivalents) and in line with the exemptions from certain own funds requirements for portfolio managers with limited MiFID permissions under CRR. Nonetheless, it is recognised that any different treatment for CLOs in Europe may have to be based on explicit conditions which provide assurance that (i) investors' interests will be protected and any potential conflict of interest appropriately managed, and (ii) this treatment will only be available to vehicles which meet objective criteria. Our proposals for exemption or less onerous retention requirements are set out in Question 9 below.

3.2 *Cost of retention for CLO managers*

CLO sponsors meet the retention requirement using one of two of the five retention options – option 405(1) (a) ("vertical slice") or option 405(1)(d) ("first loss").

As most CLO managers do not deal as principal or underwrite financial instruments, they need to hold capital in an amount of i) the greater of their capital requirement for credit risk, or ii) an amount representing a quarter of their fixed overheads, under CRR. Prior to the retention requirements coming into force, many managers did not take any credit risk, and were therefore calculating capital based on their fixed overheads.

In holding the retention by way of first loss, assuming an unrated tranche of subordinated debt, managers applying the standardised approach to credit risk would have to apply a 1250% risk weight to their securitisation position. With a typical deal size in a CLO 2.0 being around €400m, a 5% holding as a first loss position will require capital of €20m.

To hold a vertical slice of the transaction, the manager needs to hold 5% of each of the tranches sold to investors (including 5% of the first loss tranche). Assuming a transaction with a total issuance of €400m, including €45m of subordinated debt. The capital charge on a 5% vertical slice is set out below:

Class of Notes	**Amount (€m)**	**Rating**	**Credit Quality Step**	**Risk Weight %**	**5% (€m)**	**Capital Charge (€m)**
Class A	215	AAA	1	20	10.75	0.17
Class B	50	AA	1	20	2.50	0.04
Class C	30	A	2	50	1.50	0.06
Class D	20	BBB	3	100	1.00	0.08
Class E	30	BB	4	350	1.50	0.42
Class F	10	B	5	1250	0.50	0.5
Sub Notes	45	N/A	N/A	1250	2.25	2.25
Total					**€20m**	**€3.52m**

The total capital charge to the CLO manager for holding a vertical slice on this example transaction is €3.52m, against a €20m capital requirement for holding a first loss position. As mentioned in Question 10, most CLO managers do not hold any of the underlying portfolio prior to the CLO transaction and the retention rule will always involve a significant increase in capital and costs, unlike bank originators who (i) can benefit from lower capital charges by securitising, or at least have those capital charges capped at the capital charge which applied to the underlying portfolio and (ii) are able to apply the IRB approach in calculating their capital charge for the retention, which will in many cases result in a lower capital charge than that produced by the standardised approach typically used by CLO managers.

As well as their own capital cost, most CLO managers will also require funding for the purchase of the retention positions. This comes with additional costs to the CLO manager - even if the retained positions are used as collateral in a secured financing they are likely to require significant initial margin to be paid to the counterparty.

4. DO RESPONDENTS THINK THAT THERE ARE ANY ADDITIONAL IMPEDIMENTS TO ISSUERS, AND IF SO, WHAT ARE THEY?

Whilst we agree with the issues raised in the section of the DP entitled "Impediments to Issuers", we believe that there are additional regulatory constraints which impact managers in structuring CLO transactions, contracting with counterparties to the transaction and ensuring the optimum management of the portfolio for investors.

4.1 Regulatory impediments

EMIR and availability of Swap Providers

Whilst CLO vehicles will only be entering derivatives for the purpose of hedging currency and interest rates between the underlying assets and the notes issued by the vehicle, the clearing obligation in EMIR is measured by reference to the group of which the vehicle is part. As swap counterparties cannot determine the level of OTC derivatives entered by any such group, and as the boundary of such a group is unclear in any given case due to lack of clarity in the EMIR text, they typically require issuers to represent that the CLO vehicle is a non-financial counterparty below the clearing threshold. Should this be incorrect at any time during the term of the swap, the swap counterparty will then be able to terminate the swap.

However, for the same reason, Issuers are often unable to determine the boundaries of their EMIR "group" for the purpose of the clearing threshold. This leaves uncertainty as to whether the CLO vehicle will be able to enter into its rate and currency swaps at the point at which the manager buys non-euro assets into the portfolio, as if the vehicle were above the clearing threshold due to group derivative contracts, any such swap would need to be cleared and margin provided to the CCP. As the issuer will have no additional collateral to answer margin calls, there could potentially be a failure to pay and a swap termination. As a result, managers now need to disclose to investors that in the event the issuer is or becomes part of a group whose notional value of derivative contracts is over the clearing threshold, the CLO will not be able to invest in non-euro assets due to being unable to enter the hedge. The result of that is that the regulation is fettering the manager's ability effectively to manage the portfolio.

A specific exemption from the clearing obligation for securitisation vehicles which are only using derivatives for qualifying hedges would potentially have removed this issue.

Similarly, the trade reporting obligations under EMIR have led to CLO vehicles and their managers having to delegate reporting to the hedge counterparty. This increases costs in the transaction which inevitably are passed on to investors. Again, an exemption for securitisation SPVs would have solved this issue - whilst the trade would still be reported by the financial counterparty, and would be part of the financial counterparty's risk mitigation obligation.

The recently-published draft Regulatory Technical Standards detailing the requirements for exchange of collateral under Article 11(3) of EMIR (the "Margin RTS") compound the problem as again there is no specific exemption for securitisation vehicles. Typically, credit support arrangements between the SPV and the swap counterparty would operate in one direction, so that margin is only posted to the SPV as collecting party. This is a result both of rating agency requirements that the counterparty posts collateral, and the fact that the SPV has no ability to post cash or securities as collateral to the swap provider. Whilst CLO vehicles are usually incorporated in the EU and may be able to make use of the various opt-outs available in the Margin RTS, again this will depend on the SPV being below the clearing threshold and the attendant problems this raises. Furthermore it is not clear that the opt-out can work in one direction, so as to allow securitisations to continue their present hedging arrangements.

As mentioned in the DP, the universe of swap providers who can meet rating agency requirements for CLOs is already limited. Those who are operating in this market require comfort as to the issuer's NFC- status under EMIR. It is becoming commonplace for swap providers to insist on termination rights in the event that the issuer is deemed to be over the clearing threshold due to the OTC derivatives position.

AIFMD and "AIFs"

AIFMD fails clearly to exempt CLO vehicles from the definition of an Alternative Investment Fund (**"AIF"**). The exemption for securitisation special purpose vehicles (the **"SSPE Exemption"**) is drafted with reference to a different definition of securitisation from that used in CRR, and refers to an SPV acquiring obligations from "an originator", whereas a CLO vehicle acquires assets by purchasing them in the market. Whilst most EU competent authorities appear to be taking the view that a CLO issuing vehicle will nevertheless not be treated as an AIF, ESMA has not as yet given any guidance on whether the SSPE Exemption extends to CLOs and as a result, there is uncertainty as to whether CLO transactions could effectively be brought within the AIFMD compliance regime. Quite apart from the increased costs of compliance, which would ultimately be passed on to investors, if required to register as AIFMs, CLO managers would be unable also to hold the requisite MiFID authorisation which will allow them to qualify as a sponsor under CRR.

As some jurisdictions have not given clear indications that CLO vehicles are exempt from the definition of an AIF, managers have no clear guidance as to whether they can market CLOs into those jurisdictions.

5. **DO RESPONDENTS AGREE THAT MARKET LIQUIDITY MAY BE A BARRIER TO A WELL-FUNCTIONING SECURITISATION MARKET?**

Although we are not sure what else is meant by a "well-functioning" market besides liquidity (default rates are dealt with below), the question appears somewhat self-evident. Liquidity is a vicious (or virtuous) circle. If the CLO market is constrained in size by regulation it will inevitably be less liquid, whilst more issuance results in greater liquidity. However the CLO market does not currently suffer from liquidity problems. There are no public data available on trading volumes for European CLOs, but in the U.S. some, though not all, trades are reported in TRACE. Recent data there show that in 2013, some $78.7 billion of CLO paper was traded, so this is a market that investors understand and continue to support.

6. **THE VIEW OF THE BANK OF ENGLAND AND THE ECB IS THAT A 'QUALIFYING SECURITISATION' SHOULD BE DEFINED AS A SECURITY WHERE RISK AND PAY-OFFS CAN BE CONSISTENTLY AND PREDICTABLY UNDERSTOOD. DO RESPONDENTS AGREE WITH THIS DEFINITION? WHAT CHARACTERISTICS OF A 'QUALIFYING SECURITISATION' NOT ALREADY INCLUDED IN THE PRINCIPLES IN BOX 3 SHOULD WARRANT SUCH TREATMENTS?**

6.1 *Consequences of certification need to be addressed*

The DP does not specify what the consequences of classification as a qualifying securitisation may be. As such, it is not possible to answer this question on the basis of the DP as it is currently presented. With that in mind we have the following comments:

If it is the case that a qualifying certification means, for instance, that the due diligence requirements for investors are to be streamlined, or standard form reports produced, then "a security where risks and pay-offs can be consistently and predictably understood" is appropriate. This suits some securitisation asset-classes better than others - managed CLOs are backed by a portfolio which is traded and the constitution of which can change significantly over time. Thus the value of standard-form loan-by-loan reporting on day one is diminished, and the value of reporting that confirms compliance with the tests is heightened. However, investors are in fact able to see the portfolio on a regular basis, and can model through stress scenarios themselves using Intex, and potentially price the underlying portfolio using third party providers such as LoanX and Markit. This is a level of transparency which is not available to investors in other securitisation asset-classes.

If however a qualifying certification results in reduced capital requirements for those securitisations which qualify, and increased capital for those that do not, then this should be based on probability of default and loss given default in the securitisation position being addressed, and should not be based primarily either on asset class or standardisation of reporting. Capital is a "creditors' buffer", and exists to absorb losses before creditors will suffer a loss. Standardisation of documentation, nor conformed prospectuses, nor the level of understanding of the investor have any effect at all on the probability of and loss given default in the transaction. As such, our view is that structural characteristics of transactions which reduce the risk to the investor should also reduce the capital charge. With respect to CLOs, these are outlined in response to Question 7 below.

7. **DO RESPONDENTS HAVE ANY COMMENTS ON THE PRINCIPLES IN BOX 3?**

Paragraph 124 in Box 3 states that "securitisations with particular structural features - with respect to underlying assets and structural safeguards - have performed better than for the structured finance market as a whole". We agree with this statement. However we strongly urge the ECB and the Bank of England to determine "performance" in this context based on actual default rates and not based on the occurrence of rating downgrades on securitisation tranches.

Our view is that EIOPA, in its distinction between Type A and Type B securitisations, has focused too heavily on rating actions, to the exclusion of actual performance and the structural features driving it. The following table updates the default and downgrade rates for various ABS asset-classes in Europe between mid-2007 and Q4 2013, (the Q3 figures were relied on by EIOPA in the 2013 report):

Summary of Mid-2007 to Q4 2013 Ratings Transition, Default, and Withdrawal Rates						
Asset class	**Total (bil. €)**	**Upgraded (%)**	**Stable (%)**	**Downgraded (%)**	**Defaulted (%)**	**Withdrawn (%)**
ABS	170.3	4.9	66.8	28.3	0.1	82.1
Non-credit card consumer ABS	68.0	8.9	61.5	29.6	0.1	87.8
Other ABS	69.1	3.4	57.6	39.1	0.0	70.6
Leveraged loan CLOs	70.6	2.3	31.4	66.3	0.1	23.9
RMBS	756.0	0.9	58.7	40.2	0.1	59.7
SME	103.0	0.8	52.8	46.4	0.4	69.7

Source - S&P "Transition Study: 12-Month Rolling Default Level Drops To Its Lowest Since Mid-2010"- 28 April, 2014.

The table shows that despite downgrades, Leveraged Loan CLOs have a *default* rate of only 0.1% - *the same as overall RMBS and non-credit-card consumer ABS*, both of which asset-classes are included in EIOPA's "Type A" securitisation category. Furthermore, securitisations of SME loans, which are also included in Type A, have a default rate *4 times* that of CLOs. We comment above in our response to Question 2 on the principal drivers of the upgrade/downgrade statistics - which are explained in part by amendments in rating agency criteria and not actual performance. Furthermore, these figures are largely based on the performance of CLO 1.0 transactions, issued pre-crisis.

CLO 2.0 transactions, issued since 2013, have generally been structured more conservatively than their pre-crisis counterparts. European CLO 1.0 structures typically featured lower senior debt attachment points (around 30%) than those which are featuring in CLO 2.0s (typically at least 40%) meaning that senior note-holders benefit from increased levels of subordination in CLO 2.0 structures. In addition, CLO 2.0 governing documentation places more restrictions on manager behaviour relative to their CLO 1.0 counterparts. Shorter re-investment periods (3-4 years versus 5 years) reduces the time-frame over which the manager can re-invest proceeds. There are more onerous restrictions over what assets can be purchased, with synthetic or structured finance exposures not permitted and, on occasion, strict limits placed on the purchase of loans from peripheral economies and those "covenant-lite" in nature.

Aside from this, the following structural features of CLOs reduce risk to investors and should be considered in applying any quality certification which affects the capital risk weight applied to the securitisation position:

7.1 *Risk-reducing characteristics of managed CLOs*

We cannot stress too heavily the fact that the assets in a CLO portfolio are only a part of the performance of the CLO itself. As we state above, CLOs give investors the ability to invest in the loan market with the benefit of structural enhancements and active management which significantly reduce risk to the senior noteholders when compared with a direct investment, or with a static loan portfolio. The EIOPA Type A criteria, in focusing on the asset-class, have failed to recognise the weight that should be given, uniquely in this asset class within the securitisation space, to structural deleveraging and active management.

7.2 *Structural deleveraging*

In summary, structural deleveraging in a CLO interrupts the normal priority of payments in the event that the quality of the portfolio falls below a certain level. The debt coverage tests measure the amount of over-collateralisation in the CLO. In a managed CLO transaction, there is typically a maximum of 7.5% CCC (or below) rated assets in the portfolio. If these low-rated assets rise above that percentage, those assets will be treated as valued at market value rather than at the usual par value in meeting the debt coverage tests. If the debt coverage tests fail as a result, no interest can be paid out on the junior notes, the majority of the CLO management fees and all receipts from the assets will go to pay principal on the senior notes sequentially until the pool complies again with the coverage tests. The same applies to failure of the coverage tests as a result of defaulted assets. Thus the senior notes benefit both from the credit enhancement provide by the junior tranches *and* the protection of senior income and principal *prior to* any default. In a static-pool securitisation, whilst mechanisms may be built in to ensure excess income supports deficiencies on the senior notes, this is not done on a managed basis. This structural deleveraging was partly responsible for the subsequent upgrades on many of the AAA CLO tranches which were downgraded by S&P in 2009.

In addition, post the expiry of a CLO reinvestment period, to the extent that portfolio collateral is repaying and the manager is unable to reinvest these proceeds (the circumstances are usually related to note ratings or certain test compliance), these proceeds are ultimately repaid to note holders in order of seniority. This is another mechanism by which structural deleveraging can occur and is an inherent characteristic across European CLO 1.0 and 2.0 structures.

7.3 *Portfolio management*

Management of a CLO portfolio is subject to collateral quality tests, overcollateralization tests and concentration limitation tests (the **"Tests"**) - rigorous rating agency tests measuring over-collateralisation and various portfolio characteristics which the manager is required to comply with in order to continue to be able to reinvest in new assets. These portfolio-level tests are already industry-standard and are particular to managed CLOs as opposed to securitisations of static portfolios. The Collateral Manager has to meet the Tests on an ongoing basis or cash will be used to redeem the transaction.

The Tests also allow the manager to provide detailed and transparent disclosure to investors in respect of the portfolio (see below). They cover data such as diversity of obligor by industry and geography, weighted average spread on the assets, weighted average fixed rate coupon, weighted average rating and weighted average life of the underlying assets.

Unlike traditional asset-backed securities, the underlying portfolios of CLOs are typically not purchased from one originator or seller but are typically sourced in the primary or secondary market by regulated investment managers who are independent of any originator or seller of the loans. The CLO investment manager is able to independently assess the quality of the portfolio and is free of the negative incentives which can arise in an originate-to-distribute securitisation model.

Maturity mismatch should not lead to a concern for managed CLOs. The portfolio eligibility criteria typically include the condition that no asset can have a maturity date falling after that of the notes. Furthermore, the Tests include a weighted average life test, which must continue to be satisfied, or if failing, improved in order for the manager to continue to reinvest proceeds from the portfolio. The weighted average life test works to ensure smoother repayments of principal over the life of the transaction. To the extent that assets in the portfolio are maturing following the end of the reinvestment period, the notes can be repaid and will amortise, and at any time during the transaction a clean-up call is typically available to the manager once the value of the portfolio falls below a target amount.

7.4 *Prepayment risk reduced*

As outlined above, during the reinvestment period which continues for 4-5 years after closing principal proceeds are reinvested by the CLO in new assets. Following the end of the reinvestment period, unscheduled principal proceeds can still be reinvested subject to there being no breach of the portfolio tests. This means that there is a reduced risk of pre-payment of notes prior to their scheduled amortisation when compared with a static pool of loan assets.

7.5 *Credit quality of underlying assets*

As mentioned above, we believe that the assumptions regarding the quality of underlying assets which have led to CLOs falling outside the proposed class of "high-quality" securitisations in the EIOPA 2013 report are incomplete.

The assets in a CLO portfolio are purchased according to the eligibility criteria, which specify the conditions for individual loans, such as jurisdiction, rating, non-convertibility, tax and regulatory conditions etc., and as at the effective date the portfolio profile and collateral quality tests must be satisfied. CLO managers may also only invest in assets during the reinvestment period if following investment, the portfolio profile and collateral quality tests remain satisfied or if not satisfied, they must be improved following such investment. These tests ensure diversification of assets by industry, limit maximum concentration in a single borrower or borrower type, and ensure quality of loan covenants etc. The active management of the portfolio ensures the continued compliance with these tests. Thus CLOs have built-in protection for the quality of the assets in the portfolio.

Furthermore, it is worth noting recent trends in certain illustrative credit metrics of the underlying loans in which CLOs typically invest. The trend speaks to more conservative leveraged loan deal structuring which helps to lower the overall risk of an investment opportunity the CLO chooses to participate in:

- The increasing level of retained equity in the underlying leveraged loan transactions in which CLOs invest (42.37% in 2013 versus 33.64% in 2007[10] indicates that, as a percentage of the value of the business in question, private equity sponsors are contributing more of their own funds and are less reliant on debt to help fund the overall purchase price. Investors in the debt benefit from higher valuation coverage and increased equity subordination.

- Ratios of EBITDA to cash interest on debt are one way to analyse the ability of businesses to service the cash interest component of their debt service obligations. Increasing multiples of EBITDA to cash interest (4.18x in 2013 versus 2.47x in 2007)[11] indicate that, from the outset of any particular transaction, businesses can more easily cover their debt interest obligations compared to pre-crisis transactions.

- Finally, specifically looking at the senior secured component of a company's capital structure (to reflect where a CLO is most likely to lend money), ratios of senior secured debt to EBITDA have been trending down (3.73x in 2013 versus 4.56x in 2007).[12] This generally reflects more conservative deal structuring, resulting in more sustainable capital structures over the lifecycle of these leveraged loan transactions when compared to pre-crisis counterparts.

Our response to Question 20 contains comments on the specific criteria proposed in Box 3.

8. **DO RESPONDENTS THINK THAT A LIQUID MARKET FOR 'QUALIFYING' SECURITISATIONS USED FOR FUNDING WOULD RESULT FROM A 'QUALIFYING CERTIFICATION'?**

There will almost inevitably be a better perception of a product with a qualifying certification than of one without, and a probable increase in liquidity. However this does not mean that the quality of that product is increased. See our response to Question 9 below.

The corollary of this is that products without the qualifying certification could see a substantial reduction in liquidity, and a widening in spreads, although default rates will not have changed. Ultimately, certification could be yet another regulatory hurdle which may prove worthless as it does not alter the underlying level of risk of investing in a product.

9. **THESE PRINCIPLES MAY THEN PROVIDE A FRAMEWORK TO AID VARIOUS AUTHORITIES AND MARKET PARTICIPANTS TO SET THEIR OWN ELIGIBILITY CRITERIA. HOW MIGHT SUCH A FRAMEWORK BE DEVELOPED? WHAT ROLE COULD THE APPROPRIATE AUTHORITIES PLAY IN THE PROCESS OF CERTIFYING THAT A TRANSACTION IS A 'QUALIFYING SECURITISATION'? WHAT ARE THE ASSOCIATED RISKS?**

Again, the appropriateness of development of a framework which certifies some transactions as "high quality" depends on the consequences of such a certification. An implicit regulatory stamp of approval will inevitably mean that investors rely to an extent on that stamp as a representation that the product is lower-risk, particularly if the associated capital risk-weights are lower than other similar products without such a stamp. This could actually result, not in investors taking necessarily better investment

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10 Source - S&P LCD

11 Source- S&P LCD

12 Source - S&P LCD

decisions, but instead investing in a smaller universe of securitisation instruments. The resulting positive correlation in an investor's portfolio would mean potentially greater losses should default levels in an asset-class increase.

In order to reduce the risk of such positive correlation, we would argue for a greater set of asset-classes being included in any "high-quality" certification - and instead the certification to be based on the structural protections built in to the transaction. Existing protections in CLOs are outlined above in response to Question 7.

In addition to those protections, we would suggest that a CLO which complies with the following criteria should be included in any "high-quality" class of ABS which receives preferential regulatory treatment:

(a) the securitised exposures must be managed on a continuing, discretionary basis by:

 (i) an EEA investment firm which is required to be regulated in its Home member State and which is subject to the Markets in Financial Instruments Directive ("**MiFID**") or an affiliate thereof; or

 (ii) a firm authorised under the Alternative Investment Fund Managers' Directive ("**AIFMD**") or an affiliate thereof; or

 (iii) a firm or an affiliate thereof which would fall within (A) or (B) above if its head office was situated in the EEA and which is subject to equivalent regulation in relation to the conduct of its business and its management of conflicts as a firm established in the EEA (for instance investment advisors registered under the US Investment Advisers Act of 1940, as amended);

(b) the CLO investment manager of the securitised exposures must undertake to the investors in the securitisation to comply with the regulatory requirements applying to it in relation to the management of conflicts of interest, in connection with its management of the securitised exposures (i.e. compliance with MiFID and/or AIFMD);

(c) the securitisation must contain provisions whereby the interests of the CLO asset manager are appropriately aligned with the interests of the investors during the whole life of the securitisation. It is recognised that this may be achieved by a material part of the manager's compensation for carrying out its duties being structured as an incentive fee, which will only become payable upon appropriate performance thresholds of the securitised exposures having been met;

(d) Investor reports should be provided monthly;

(e) In addition, the following portfolio characteristics could be provided for in a definition of CLOs to ensure that only certain types of structures would actually constitute a CLO:

 (i) it contains a high percentage of senior secured bonds or loans to corporates;

 (ii) it does not contain any asset-backed securities or synthetic securities; and

 (iii) it is managed by an independent investment firm or an affiliate thereof which satisfies paragraph (a) above and who independently reviews, and individually selects, each asset to purchase in the primary or secondary market (with no obligation to purchase from any individual bank or originator);

In terms of the role of the authorities in the certification process, questions of liability for losses incurred by investment in instruments certified by the authorities would need to be addressed. The certification process could also cause potentially costly delay in closing, as disclosure would need to be made as to the certified status of the notes in the Prospectus.

10. **DO RESPONDENTS THINK THAT HARMONISATION AND FURTHER CONVERSION SOFTWARE COULD BRING BENEFITS TO SECURITISATION MARKETS? IF SO, WHICH ASSET CLASSES SHOULD BE TARGETED? HOW CAN ACCESSIBILITY TO THE EXISTING LOAN LEVEL DATA BE IMPROVED, SO THAT IT PROVIDES MOST VALUE TO INVESTORS?**

As there are no current ECB and Bank of England disclosure templates for CLO transactions, the question regarding conversion software is not applicable to this product.

Some harmonisation is of benefit to the CLO market. In principle, we have no objection to harmonised prospectuses and investor reports as long as the industry is involved in their development and issues of confidentiality are addressed. However, as the portfolio is managed, its composition changes over time and as a result our view is that loan-by-loan information is of less importance for managed CLOs than it would be for a static pool. See further our responses to question 12 below.

11. **DO RESPONDENTS THINK THAT INITIATIVES CURRENTLY UNDERTAKEN BY AUTHORITIES IN THE AREA OF STANDARDISATION OF PROSPECTUSES AND INVESTOR REPORTS AND TRADE TRANSPARENCY ARE SUFFICIENT OR IS THERE SCOPE FOR FURTHER IMPROVEMENTS? WOULD THE AVAILABILITY OF PROSPECTUSES AND STANDARDISED INVESTOR REPORTS IN A SINGLE LOCATION BE HELPFUL TO SECURITISATION MARKETS?**

We do not have strong views on this.

12. **DO RESPONDENTS AGREE THAT FACILITATING INVESTORS' ACCESS TO CREDIT DATA IN AN APPROPRIATE MANNER COULD SUPPORT THE EMERGENCE OF SECURITISATION MARKETS? WOULD CREDIT REGISTERS BE HELPFUL IN THIS RESPECT? IF SO, WHICH ASSET CLASSES SHOULD BE TARGETED? IN WHAT FORM COULD ACCESS BE GRANTED TO ENSURE THAT BORROWERS' CONFIDENTIALITY IS PRESERVED?**

The Bank of England Discussion Paper "Should the availability of UK credit data be improved?" from May 2014 suggests that the availability of credit data is not a concern in the large corporate credit market. We have no reason to disagree with this conclusion. Investors are attracted to private debt as it gives them access to a higher degree of control over assets and the ability to limit the downside through covenants, step-in rights and security, and access to credit data is not currently a concern.

13. **IN ORDER TO AID PERFORMANCE MEASUREMENT AND TO PROVIDE INVESTORS WITH INDUSTRY-LEVEL DATA, WOULD IT BE HELPFUL IF CERTAIN MACRO-ECONOMIC DATA WERE DISCLOSED OR IF BANKS/ NON-BANKS PUBLISHED CERTAIN AGGREGATED STANDARDISED DATA? WHAT ARE THE CHALLENGES OF PROVIDING POTENTIAL INVESTORS WITH SUFFICIENT BORROWER AND LOAN-LEVEL DATA TO ENABLE THEM TO MODEL CREDIT RISK, AND HOW CAN THESE BE OVERCOME? WHAT OTHER ELEMENTS WOULD IN YOUR VIEW HELP TO IMPROVE SECONDARY MARKET FUNCTIONING FOR HIGH-QUALITY SECURITISATION?**

Current disclosure to investors in the CLO market

As investors are returning to the CLO market our view is that they are finding the pre-investment disclosure adequate to comply with their due diligence requirements. The eligibility criteria for the assets are set out in the prospectus. The prospectus also tells investors what the content of investor reports will be on an ongoing basis following investment. If it would assist the ECB and the Bank of England we would be very happy to supply some more detail around the types of information included in monthly CLO investor reports. Our view is that this information is sufficient.

Investor reports are issued monthly to investors, containing the information set out in the Prospectus. These reports provide, subject to any confidentiality restrictions binding on the CLO vehicle, the principal balances of underlying loans, the location of the security, the domicile of the obligor, the rating, the industry category and the stated maturity.

Compliance with collateral quality, concentration limits and debt coverage tests will also be confirmed in the monthly investor reports along with the loan disclosure already provided. In this way, investors receive a wealth of information on the loans in the CLO portfolio on which to base their due diligence, and on which they can run their own models using Intex. Additional loan-by-loan information is of little additional value as there is no assurance that an individual loan will remain in the portfolio from month to month – what investors are really buying is the expertise of the Collateral Manager to manage a portfolio of loans in accordance with certain known parameters.

14. **DO RESPONDENTS THINK THAT AUTHORITIES SHOULD CONSIDER ENCOURAGING THE INDUSTRY TO DEVELOP SUCH BENCHMARK INDICES? WHAT RISKS MIGHT THESE GIVE RISE TO? WHAT INDICES WOULD BE USEFUL AND WHICH COULD BE EASILY PRODUCED?**

The CLO industry already uses benchmark indices for tracking the performance of underlying collateral, e.g. the Credit Suisse Leveraged Loan index.

With regard to benchmark indices of CLO tranches, we believe these are not necessary - investors already look at historic new-issue spreads, and ratings actions on existing tranches, and benchmarks of tranche performance will not add significantly to the information already available, whilst potentially creating reliance by investors on the benchmark rather than comprehensive due diligence.

15. **DO RESPONDENTS AGREE THAT ADDITIONAL INFORMATION IN THE FORM OF A MATRIX SHOWING IMPLIED RATINGS IF THE SOVEREIGN AND ANCILLARY FACILITIES RATING CAPS WERE TO BE SET AT HIGHER LEVELS WOULD BE HELPFUL IN SUPPORTING THE INVESTMENT PROCESS AND CONTRIBUTE TO INCREASED TRANSPARENCY AND LIQUIDITY?**

Sovereign ratings caps do not generally impact leveraged-loan CLOs as they are geographically diverse and therefore not dependent on the rating of a single sovereign.

16. **HOW IMPORTANT DO RESPONDENTS SEE THE IMPEDIMENT RELATED TO THE AVAILABILITY OF ANCILLARY FACILITIES? WOULD THE BENEFITS OF FACILITATING SPV BANK ACCOUNTS THAT FALL OUTSIDE THE ORIGINATOR'S INSOLVENCY ESTATE OUTWEIGH THE COSTS OF SUCH AN INITIATIVE? ARE THERE OTHER INITIATIVES IN THIS AREA THAT WOULD BE BENEFICIAL?**

(*NB: The reference to the originator's insolvent estate in Question 16 seems to differ from the context – the DP here talks about the account bank's insolvent estate and therefore our response concentrates on that. Issuer/transaction accounts will already be outside the Originator's insolvent estate in a CLO*).

Whilst this could in theory increase the number of banks able to act as account providers to the SPV, finding a way to isolate cash in an account from the account bank's insolvent estate is extremely difficult as a bank account is simply an unsecured contractual claim against the bank for the return of the cash standing to the account. For example, as a matter of English law, isolation of assets from the asset-holder's insolvent estate would require a an outright assignment (or "true sale"). It is not possible for a bank to assign to the SPV the debt it already owes to the SPV and thus not possible for the bank to isolate the account balance from its insolvent estate. A legal framework for creating such isolation would be useful however it would require changes to insolvency law throughout Europe.

However, there is no real shortage of bank account providers for CLO transactions. There are limited options for swap providers, but this is largely due to rating agency counterparty criteria, which require stringent protection against downgrade of the swap counterparty rather than the complexity of the swaps themselves.

17. **WITH REGARD TO THE POLICY OPTIONS MENTIONED, ARE THERE ANY OTHER CONSIDERATIONS AUTHORITIES SHOULD BE MINDFUL OF?**

See Conclusion below

18. **DO RESPONDENTS THINK THERE ARE OTHER POLICY OPTIONS AUTHORITIES SHOULD CONSIDER TO SUPPORT THE EMERGENCE OF SIMPLE, TRANSPARENT AND ROBUST SECURITISATION MARKETS?**

See Conclusion below

19. **BEYOND SECURITISATION, MIGHT THERE BE OTHER WAYS OF ACHIEVING (SOME OF) THE BENEFITS OF SECURITISATION AS OUTLINED IN SECTION 2? WHAT MIGHT BE THE ASSOCIATED RISKS OF SUCH OPTIONS?**

See Conclusion below

20. **DO THE PRINCIPLES SET OUT IN BOX 3 SEEM BROADLY SENSIBLE GIVEN THE OBJECTIVE OF ENCOURAGING A SET OF SECURITISATIONS THAT ARE MORE AMENABLE TO RISK ASSESSMENT? ARE THERE ANY OBVIOUS UNINTENDED CONSEQUENCES?**

We refer to our responses to Questions 6 to 9 above. Further, Annex II sets out our specific comments on the individual criteria within Box 3 when applied to a CLO transaction.

Conclusion

Managed CLOs sit uncomfortably in the securitisation space. They do not have a single originator who is involved in the transaction. There is no significant risk transfer. The sponsor (being the CLO manager) did not (prior to the retention rules) take significant exposure to credit risk. The assets are not static, and whilst clearly they provide the cash flows which provide the payments on the notes, the structure of the transaction is equally important to the CLO's risk profile. As such, new securitisation regulation frequently impacts CLOs in ways which are possibly unintended, and are certainly disproportionate when compared with actual default rates.

In creating any new distinction between "high quality" securitisations and what will inevitably (though inaccurately) be seen as "low quality" securitisation, we would strongly urge the regulators to engage with us in depth to consider the impact of generic treatment of securitisation on the CLO universe, and the knock-on effect on lending to the real economy.

We would be very happy to answer any further questions you may have and are keen to assist the Central Banks further in considering any proposals which may affect CLOs. If you would like us to do so, please contact Nicholas Voisey of the Loan Market Association (nicholas.voisey@lma.eu.com), or David Quirolo (david.quirolo@ashurst.com) or Anne Tanney (anne.tanney@ashurst.com) of Ashurst.

Yours faithfully

N A Voisey

Nicholas Voisey

ANNEX I - EIOPA "Type A" Securitisations CLO comments

Requirement		CLO comments
(a)	the exposure has been assigned to credit quality step 3 or better;	Senior CLO notes will meet this requirement
(b)	the securitisation is listed in a regulated market of a country which is a member of the EEA or the OECD;	CLOs in Europe are currently mainly listed on unregulated markets (such as GEM in) Ireland and also the regulated market in Ireland. There would be no difficulty for CLOs to list on the regulated market if required.
(c)	after the delivery of an enforcement notice and where applicable an acceleration notice, the tranche is not subordinated to other tranches of the same securitisation transaction or scheme in respect of receiving principal and interest payments;	The Class A notes of a CLO will meet this requirement
(d)	the underlying assets have been acquired by the SSPE in a manner that is enforceable against any third party and are beyond the reach of the seller (originator or sponsor) and its creditors including in the event of the seller's insolvency;	The CLO will purchase underlying assets in the open market and the originator will not be involved in the securitisation and will have no recourse to the assets. Market standard loan purchase documentation includes solvency representations from the seller. True sale opinions are delivered on some transactions.
(e)	there are no severe clawback provisions in the jurisdiction of the seller (originator or sponsor); this includes but is not limited to provisions under which the sale of the underlying assets can be invalidated by the liquidator of the seller (originator or sponsor) solely on the basis that it was concluded within a certain period before the declaration of the seller's insolvency or provisions where the SSPE can prevent such invalidation only if it can prove that it was not aware of the insolvency of the seller at the time of sale;	In the typical jurisdictions in Western Europe whose laws govern the transferor's insolvency, there is no clawback available to the insolvency official or administrator of the transferor. Market standard loan purchase documentation includes solvency representations from the seller. True sale opinions are delivered on some transactions.
(f)	the securitisation includes provisions to ensure that a	Servicing continuity is provided for in a CLO, as managers cannot step down until

default of the servicer does not result in a termination of servicing and provisions to ensure the replacement of derivative counterparties and liquidity providers if applicable;	a suitable replacement is appointed. Similarly, swap counterparty replacement is hard-wired into the documentation and must comply with rating criteria.
(g) all the assets underlying the securitisation belong to only one of the following categories:	
[(i) lists eligible asset classes]	Does not include CLOs - CLOs cannot currently comply
The pool of underlying assets may only include derivatives if these are used strictly for hedging currency risk and interest rate risk.	CLO 2.0 portfolios do not include derivatives. Swaps are only entered by the issuer if the CLO needs to hedge currency (or interest rate).
(h) the pool of underlying assets do not include loans that were granted to credit-impaired obligors; where a credit-impaired obligor is a borrower (or where applicable, a guarantor) which:	
(i) has declared bankruptcy, agreed with his creditors to a debt dismissal or reschedule or had a court grant his creditors a right of enforcement or material damages as a result of a missed payment within three years to the date of origination; or	Defaulted Assets are not eligible to be purchased for CLOs.
(ii) is on an official registry of persons with adverse credit history; or	Not applicable as CLO assets are loans to corporates.
(iii) has a credit assessment by an ECAI or has a credit score indicating a significant risk that contractually agreed payments will not be made compared to the average obligor for this type of loans in the relevant	All assets require a rating from each rating agency rating to CLO.

	jurisdiction.	
(i)	the pool of underlying assets do not include loans in default within the meaning of Article 178(1) of Regulation 575/2013 (Mortgage Credit Regulation) at the time of issuance of the securitisation or when incorporated in the pool of underlying assets at any time after issuance;	Loans in a CLO are to corporate entities - defaulted loans will not be included in the portfolio as defaulted either at the date of securitisation or on subsequent purchase
(j)	except for securitisations where the underlying assets are credit card receivables, at least one payment has been made by obligors on the loans or lease;	CLO assets are comprised of loans to corporate borrowers. Some of these loans are primary insurance and will not yet have a payment date. Given loans are to corporates rather than individuals, our view is that this requirement should not apply to CLOs.
(k)	to (l) apply to mortgages and consumer loans and as such do not apply here;	Not applicable to CLOs
(l)	where the issuer, originator or sponsor of the securitisation is established in the Union, it discloses information, in accordance with Article 8b of Regulation 1060/2009, on the credit quality and performance of the underlying assets, the structure of the transaction, the cash flows and any collateral supporting the exposures as well as any information that is necessary for investors to conduct comprehensive and well-informed stress tests; where the issuer, originator and sponsors are established outside the Union, comprehensive loan-level data in compliance with standards generally accepted by market participants is made available to existing and potential investors and regulators at issuance and on a regular basis.	CLOs are currently not required to comply with ESMA's regulatory technical standards for disclosure made under Article 8(b) of 1060/2009 as there is currently no ECB template for loan-by-loan disclosure for CLOs. They cannot comply and are not proposed by ESMA to be treated as in breach of the requirements of Article 8(b) as a result. Consequently, whilst we agree that high-quality disclosure is necessary, if CLOs are included in "Type A" securitisations, we propose that the disclosure is instead satisfied by satisfaction of the requirements of Article 409 of Regulation 575/2013 in the case of CLOs. As discussed above, CLO investors receive monthly reports.

ANNEX II - Box 3 proposals

ECB/BofE Criteria	CLO comments
128. **Nature of assets:** The receivables or assets underlying the securitisation must be credit claims or receivables with defined terms relating to rental payments or principal and interest payment. Any referenced interest payments should be based on commonly encountered market interest rates and may include terms for caps and floors, but should not reference complex formulae or exotic derivatives.	CLO portfolios will meet this requirement
129. **Underlying asset performance history:** Verifiable loan loss performance should be made available for substantially similar receivables to those being securitised, for a sufficient time period of at least the effective life cycle of the receivables and covering at least one period of significant market stress.	The S&P European Leveraged Loan Index shows default rates by percentage of issuers and percentage of principal amount defaulted, over 12 month and rolling 12 month periods
130. **Primary obligors:** The securitisation will have recourse to the ultimate obligors for the underlying receivables, i.e. it may not rely upon contingent or derivative-linked claims or be a securitisation of other securitisations.	CLO portfolios will meet this requirement, however, some loan assets are purchased by way of participation agreement.
131. **Expectation of payment:** The originator must demonstrate that any receivables being transferred to the securitisation are loans, advances or financings that are homogenous in respect of their asset type and consistently originated in the ordinary course of the originator's business. These can be loans, advances or financings to: • obligors who have satisfied prudent and consistent underwriting criteria and have been assessed as having ability and volition to make timely payments on obligations; or	References to the "originator" are inappropriate in typical CLO transactions. In our view an equivalent requirement could be that the manager is a regulated entity required to act in the best interests of the investors in managing the portfolio - see our response to question 9

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	• granular pools of retail consumers for which the expected cash flows have been modelled to meet stated obligations of the securitisation under prudently stressed loan loss scenarios.	
132.	**Current and self-liquidating:** Any receivables being transferred to the securitisation should be current in payment, i.e. they should not include delinquent obligations. In addition they should be self-liquidating from intrinsic cash flows, i.e. they may not rely on future borrowings, or asset sales to pay timely interest and principal.	CLO assets (at the time of purchase) are current payment obligations. The eligibility criteria require that no asset has a longer-dated maturity than the legal maturity of the notes. This means that following the end of the reinvestment period, when principal proceeds are paid to noteholders in accordance with the priorities of payments, assets may liquidate to an extent prior to maturity of the notes - however most underlying loans will be required to be refinanced rather than being self-liquidating. However, debt coverage tests are required to be met on a continuous basis. Following any breach of debt coverage test for a class of notes, interest will be used to redeem only that class of notes and those above it, until the debt coverage tests are complied with. It should be noted that other types of corporate lending including SME loans also rely on refinancing of underlying assets, so CLOs are no less robust from this perspective than SMEs, which are included in EIOPA's "Type A".
133.	**Security:** Where underlying receivables are secured on specified tangible assets, such security must be first-ranking or, if lower ranking, rights associated with all prior ranking security should all be transferred to the securitisation.	CLOs do permit a small percentage of the assets to be more junior ranking (less than 10% of the portfolio in most cases).
134.	A non-exhaustive list of examples of underlying assets that may comply with the above principles, (subject to meeting all other criteria) could include: residential mortgages, certain commercial real estate mortgages, loans to SMEs, automobile loans/leases, consumer finance loans, credit card receivables and leasing receivables.	

Structure	
135. **Perfection of interest:** The securitisation should effect true sale in its transfer of underlying receivables from the seller on terms such that the transfer of these assets: • is enforceable against any third party; and • is beyond the reach of the seller, its creditors or liquidators; and • is not effected through credit default swaps or derivatives; and • is not subject to identifiable re-characterisation or claw-back risks. Legal opinion should confirm these.	The CLO will purchase underlying assets outright in the open market and the originator will not be involved in the securitisation and will have no recourse to the assets In the typical jurisdictions in Western Europe whose laws govern the transferor's insolvency, there is no clawback available to the insolvency official or administrator of the transferor. However, as the portfolio is granular and usually purchased in the market there is typically not always separate legal opinion governing the true sale unless the portfolio is substantially coming from one seller.
136. **Observability:** To aid risk assessment, the securitisation must be able to distinguish and report all income and disbursements, i.e. scheduled principal, scheduled interest, prepaid principal, past due interest and fees and charges.	CLOs will comply with this requirement and this is included in the monthly reports.
137. **Debtor payments:** Definitions, remedies and actions relating to delinquency and default of underlying debtors must be given, in clear and consistent terms.	CLO Managers do not originate the loans. As there are multiple original lenders the terms may differ, although the syndicated loan market uses standard market documentation (such as the LMA standard loan agreements).
138. **Payment priorities:** The priorities of payments for all liabilities in all circumstances must be clearly defined at the time of securitisation.	CLOs comply with this requirement
139. **Rights:** All voting and enforcement rights related to the assets must be transferred to the securitisation and the rights associated with liabilities of the securitisation under all circumstances must be clearly defined, with the most senior rights afforded to the most senior liabilities.	CLOs comply with this requirement though the most junior class can call the CLO after a fixed period of time provided there is sufficient value in the portfolio to repay all of the notes.
Transparency	
140. **Initial data:** Sufficient loan-level or	CLOs comply with this requirement

	granular pool stratification data should be available at the time of securitisation to potential investors in order to permit construction and analysis of cash flow models. Cash flow models should also be made available.	Cash-flow models are generally available in the CLO market - see our response to Question 10.
141.	**Ongoing data and information:** Updated loan-level performance data and standardised investor reports should be made available to current and potential investors on a monthly/quarterly basis throughout the life of the securitisation.	CLOs provide monthly investor reports
142.	**Conformance with Prospectus Directive:** Notes should provide investors with access to the full range of disclosure of legal and commercial information, along with comprehensive risk factors, in conformance with those required in the Prospectus Directive.	Some (but not all) CLOs are admitted to trading on a regulated market. The disclosure standard is the same.
143.	**Servicing and counterparties:** Transaction level information, such as servicing responsibilities (and special servicing responsibilities), as well as the identity, roles, and responsibilities of all parties to the transactions should be clearly set out in the transaction documentation. The servicer should apply the same servicing policies, procedures and standards to the underlying assets that it applies to other similar non-securitised assets. Provisions should be documented for the replacement of servicers, derivative counterparties and liquidity providers in the event of failure or non-performance or insolvency (or other deterioration of creditworthiness) of any such counterparty to the securitisation.	CLOs comply with these requirements. However as the CLO Manager does not underwrite the loans, the requirement to apply the same servicing policies to non-securitised assets is not applicable.
External Parties		
144.	The securitisation should be subject to ongoing independent credit assessment, for example, by two recognised external credit assessment institution (ECAIs).	CLOs comply with this requirement
145.	The terms and documentation of the securitisation should be reviewed and verified by an authorised legal	CLOs comply with this requirement

	practice.	
146.	The initial and ongoing terms and reports for the securitisation should be reviewed by an authorised accounting practice or the Calculation Agent of the transaction	An effective date report is audited at the time the portfolio is completely ramped up. Given the frequency of reporting (monthly) it would be difficult to audit all the reports. Reports are however prepared by a calculation agent who is independent from the CLO manager.

MAF Group

Comments on a Discussion Paper
« The case for a better functioning of the securitisation market in the European Union »

jointly published by the European Central Bank and the Bank of England
on May 30, 2014

1.) The special case for SMEs

The EU is suffering from weak economic growth. Contrary to expectations, the lowering of interest rates and the easing of liquidity provisions to the banks are failing to boost bank lending to the real economy. The European SME sector is of paramount importance for growth, employment, innovation and sustained international competitiveness. At the same time SMEs suffer from a structural competitive disadvantage in obtaining finance relative to large caps. The SME sector therefore deserves special attention.

Small deal sizes below the threshold of capital markets and the resulting fixed cost character of sourcing and monitoring relatively small loan amounts are at the core of the SME sector's structural disadvantage. In addition, the availability of relevant financial information on SMEs is often fragmentary and tardy with the risks to be evaluated more heterogeneous than in any other conceivable asset class.

The argument is therefore sometimes offered that SMEs do not qualify for securitisation and improvement efforts should concentrate on more homogeneous asset classes like RMBS and ABS.

The opposite conclusion is being advanced in the following remarks.

2.) SME securitisation focus must be market-based

SME securitisations amount to a share of only 8% of all European securitisations outstanding. More than half of all new SME securitisation issues since the crisis of 2007 are not publicly placed in the market, but retained by the issuing banks as collateral for funding purposes in repurchase agreements with the ECB. In order to qualify for repo-based funding these transactions enjoy specific support from the European Investment Bank (EIB) or the European Investment Fund (EIF) via purchases of single tranches or guarantees. While the approach and procedures of these support measures appear to comply with best professional standards – as low default rates of only 0.4% indicate - such standards are not reflected in market prices for lack of turnover in the retained issues.

Although central bank repo agreements with SME collateral do provide attractive funding for the issuing bank, they do not result in any transfer of legal or economic ownership to non-bank institutional investors such as insurance companies and pension funds. Such a transfer would be healthy as the institutionals are hunting for yield in a low interest rate environment while banks continue to be under deleveraging pressures. Unfortunately, regulatory barriers continue to discriminate against investments in securitisations.

But before any positive developments can and should take place, bad loans in the European banking system in all sorts of other asset classes in an estimated amount of € 500 billion or even more still need to be cleaned up. This purgatory challenge should be part of the Asset Quality Review in the second half of 2014. Central bank market interventions into the securitisation markets prior to the successful completion of AQR and prior to subsequent resolution measures must increase market distortions. A non-discriminatory, more balanced regulatory treatment of securitisations can also unfold its full positive potential only after a thorough prior clean-up of bad assets.

An eventual evolution of the regulatory regime away from an ever more complex, contradictory and ultimately arbitrary system of risk weighted assets towards simpler rules of strict leverage limitations and of stricter links between assumed risk and liability could certainly go a long way in reviving the various securitisation markets in general. But even if that were to materialize the structural disadvantage of small SME deal sizes would remain a handicap if not addressed and resolved specifically and in an appropriate fashion.

3.) Availability of SME credit data as a public service

The Bank of England in a separate discussion paper, published on the same date as the joint ECB-BoE one which is being commented upon here, explores the question of whether the availability of credit data should be improved. Without going into the details of this second paper, it is obvious that the timely, comprehensive, continuous availabilty of SME credit data could be a very important remedy for overcoming their small deal size handicap.

But this is a non-trivial challenge for more than one reason : Who would pay for a European SME data warehouse ? Who should have access ? How can the confidentiality of proprietary information be protected which often is the reason for such companies to stay private instead of going public ? Who should manage and operate it ? If it will be a public private partnership to which originating banks both continuously contribute while simultaneously and increasingly benefitting from its profound industry sector know-how, how can it be protected from lobbying or corrupting interests? How could conflicts between competing originators be avoided? Should there be a variety of national initiatives or a central European effort?

What has come into existence already like the European Data Warehouse GmbH or the PCS initiative is focussing on real estate transactions and has not yet developed further. But both the heterogeneity and the greater fragmentation of the SME sector will definitely require an even more thorough approach to resolving important governance, control and operating issues.

If and when the EIB plus the various other European national development institutions should receive the mandate to develop a pan-European, consolidated, standard, (compulsory ?) SME securitisation platform into which deals or entire portfolios from all over the EU could be delivered, it would be natural to also put a European data warehouse capability under its wings, possibly alongside the EIF which already has developed a broad knowledge of SMEs.

The strongest counter-argument against an EIB/EIF led pan-European SME securitisation platform cum data (and deal portfolio?) warehousing would be the creation of yet another sprawling EU bureaucracy. The ever increasing number of European regulatory agencies seems to be a big enough headache already with silo mentality entrenching and obstructing rather than facilitating what the paper under discussion seeks to improve. But that may be exactly the reason why it is time to empower a strong, well-managed and disciplined counterweight of risk conscious SME securitisation enablers to balance the risk exorcising excesses of the regulators.

4.) Risk, uncertainty and SMEs

Empirical behavioural economics have revealed that we all seem to be pretty much hardwired both to overestimate our power of judgement and to spontaneously follow the herd. In the sphere of risk management this has led to a serious confusion between risk and uncertainty. The equilibrium axioms of neoclassical economics induce an additional dosis of overconfidence with regard to our perceived risk management capabilities. Based on time series of the past we calculate probabilities of events of default on payment obligations in the future with great confidence and precision and are surprised if events not taken into account intervene and confound our expectations.

In regulatory risk control discussions this spirit of overconfidence shows when there is talk of limiting investments to constellations with « predictable performance ». We can calculate the probability of contractual payment obligations being met for the next interest payment date or principal installment. But we cannot predict what the share price of company XYZ will be one year down the road. Stockpickers try very hard to gauge at least the general drift correctly. And in contrast to Modern Portfolio Theory there actually seem to exist exceptionally talented stock pickers who can outperform the index. But we should bear in mind that an SME's performance is even less predictable than the performance of a large public company, because, as a smaller company, it will generally be less robust in case of severe external shocks and our knowledge base of the company as such is much more limited. The most that statistics can tell us is a probability of default in complying with contractual payment obligations.

But a Portuguese SME can have such a strong position in non-Portuguese markets, that its overall rating may deserve to be better than that of its sovereign. Or an otherwise strong looking German SME may be exposed so deeply to a difficult region like Ukraine that we cannot understand its risk without knowing a lot more about detailed circumstances.

Thus, in the case of SMEs, „the application of large-scale largely automated scoring software and clear company-wide rules that rely on the law of large numbers, not the careful local monitoring and evalutation, to prevent excessive losses,“[1] although now commonly prevailing in theory and practice, would not be enough .

Or, in short: No „high quality“ or „prime collateral“ securitisation certificates are needed, just a hard-nosed, disciplined, vigilant and continuous assessment and support of risk-adjusted yield propositions from simple, transparent, standardised securitisation structures. To such ends an SME data warehouse with as much multiple, diverse, dispersed and independent input as feasable would prove invaluable.

[1] Quote from an FT article by a former member of the BofE's Monetary Policy Committee: http://blogs.ft.com/the-a-list/2014/06/04/the-ecb-can-and-should-make-the-abs-market-happen/

5.) Strategic Repositioning and Restructuring Capability

Privately held SMEs are often run by one single strong personality, typically with a pronounced acumen in either marketing or engineering or in both, but less often so in financial matters. This can result in mistakes, lost opportunities or even crises.

An experienced SME fund manager can develop the talent to identify such pitfalls even before they dawn on the SME owners themselves. It would greatly add to the merits of an SME data public service capability if strategic and restructuring judgment capabilities could be offered and implemented in a pro-active fashion. Such a co-operation between the public service facility and the SME management could be either a voluntary or fee-based option in case of senior borrowings. But for subordinated or mezzanine loans, which are of particular value for SMEs without access to the public equity markets, pro-active crisis prevention by the securitisation agency ought to be among the contractually stipulated creditor rights, exercisable even unilaterally in case of need.

6.) Dropping the « skin in the game » requirement

One of the legacies of the US subprime mortgage crisis is the view that an «originate to distribute » approach to securitisation must be banned or at least mitigated by strict retention requirements for the originator. This stand has been reinforced by academic writings on asymmetric information, skewed incentives and agent principal conflicts of interest.

The imposition of retention requirements for the originator obviously impairs the economics for all parties involved.

It may be useful to bear in mind that every and any buyer and seller constellation contains this essential conflict between one party wanting to sell high and the other wanting to buy low. Even so the seller, intent on maintaining her standing for future business, will characteristically try to avoid reputation damage for sharp practices.

The special feature of the US subprime mortgage market were adjustable, not long-term fixed interest rates such as for prime mortgages. These adjustments allowed the originator to renegotiate both interest rate and financing amount every two to three years by stealing the home owner's accrued equity in a market that had been continuing to go up without interruption for more than ten years. The US legislator had removed all barriers against this outrageous form of predatory lending with the otherwise laudible intention to broaden access to home-ownership for the underprivileged of US society.

While the market went up, everybody was content: The home owner enjoyed being able to buy a new car from the higher amount of the renegotiated mortgage even when that precluded the build-up of equity. The originator was careful not to kill the golden goose before the next upcoming interest rate adjustment and the investors were only too happy to receive prime rated paper with a considerable yield pick up.

What most critics have forgotten - or are papering over in covering up their own lack of scrutiny back then - is the fact that the originators kept as much of the upside to themselves as they possibly could, „distributing“ only the senior tranches and fully retaining the first loss, the equity, the mezzanine, the residual piece. And nobody had to ask them for doing so. The originators immensely profited as long as the market kept going up. And as long as the market kept going up, the rating agencies saw no need to deny top ratings to senior subprime tranches. But when the US residential real estate market stalled during the first half of 2007, the picture turned murky. The private originators immediately stopped originating and disappeared into the bushes with well-lined pockets. But demand for subprime mortgage risk continued well into the second half of 2007. By then completely opaque re-securitisations of subprime risk had emerged, in amounts largely surpassing original subprime issuing volumes, via CDOs, supported by much leveraging and short-term refinancings.

The „originate to distribute“ model seems perfectly adequate for SME securitisations with simple, transparent structures. Small regional and savings banks with excellent SME loan origination but without securitisation arrangement capabilities would otherwise be hamstrung. In the ongoing context of simple, transparent securitisation structures the risk of reputation damage will keep differences of interests in check even without retention requirements.

7.) Liquidity vs. long term hold institutional placement

There seems to be an expectation that central bank buying of SME securitisations could revive a currently stagnant, almost non-existent market. Institutional investors may be impressed by central bank purchases, but it may not trigger their own investment appetite as long as discriminatory regular barriers subsist.

As soon as a sound, standardised SME securitisation effort gets started through the initiative of EIB and/or the various European national development bank equivalents in a simple, transparent way, interest from institutions will develop along with it. Decent risk-adjusted yields will pull in institutional investments more effectively than politically administered market-making. If performance monitoring is credible, buy and hold long-term investment opportunities may be of greater interest than short-term liquidity considerations.

Lucerne, July 29, 2014

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Munich, 6/27/2014

MEAG Feedback - The case for a better functioning securitisation market in the European Union

Dear Sir or Madam,

first of all we would like to express our gratitude and support for your efforts in addressing the current situation surrounding the European securitization market. MEAG in its capacity as the asset manager of ERGO Versicherung and Munich RE is actively involved in the ABS market and thus takes a keen interest in the future development of this market. We have taken the time to respond to your questionnaire entailed in the paper "The case for a better functioning securitisation market in the European Union" and would like to herewith submit our answers to you.

If you have any further questions with regards to our replies, we would be more than happy to further discuss these with you.

Best regards

Colin Warschau, CFA
Lucia Kraus, CIIA

MEAG Feedback:

1. Do respondents agree with the **benefits of a well-functioning securitisation** market as outlined in Section 2?
    a. We fully agree with all the benefits outlined in the paper for both bank and non-bank investors as well as the originating banks (e.g. risk transfer, funding tool to support real economy etc.)

2. Do respondents agree with the impediments to and economic concerns of **investors** that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?
    a. In our view the greatest impediment to a well functioning securitization market is currently posed by the relatively punitive regulatory capital treatment (particularly when compared with similar asset types) and the great uncertainty surrounding the issue for investors. In effect, we believe this to directly feed into the latter points mentioned, namely "Behavioral constraints" and to a smaller extent "Risk assessment".
    b. We welcome the efforts of both ECB/BoE as well as market initiatives such as the PCS to standardize Reporting and promoting transparency within the ABS market which we feel will help lead to reduced investor aversion to the product going forward.
    c. It is essential to note the extraordinary positive performance of European securitization over time. The "stigma effect" of ABS lacks any fundamental justification and hence should be seen as an issue of "form over substance" Again the regulatory signaling is essential.
    d. We also deem the non-standardized regulatory treatment across different type of buyers (Basel vs. Solvency) and jurisdictions as problematic as it will potentially render an unlevel playing field e.g. for fund investors (under AIFM) missing the 5% retention rule leads to an outright investment ban, not just to higher capital requirements as is required by bank investors. Inconsistent risk retention requirements across jurisdictions in our opinion has the potential to lead to an un-level playing field and further inhibit cross-jurisdictional investments.
    e. Given the above we currently notice incentives to avoid a classification as securitisation trending towards to non-standardised bond documentations which creates increasing legal uncertainty as well as operational risks for investors.
    f. A lack of data for performance assessment purposes of some ABS. (Investors need to have access to a adequate history of data to understand how underlying loans will perform across a large variety of circumstances).

3. Do respondents agree with the **impediments to** and **economic concerns of issuers** that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?
    a. In our view the main impediment deterring issuers to more prominently utilise ABS are the current pricing levels of ABS issuance which in most cases still compare unfavorably to other means of funding (FLS/Senior secured etc). These market levels however are in turn driven by investor demand which in turn are influenced by the aforementioned regulatory capital concerns. Hence, we are seeing more non-bank issuers currently in the primary market as they do not benefit from such alternative funding tools. The additional costs mentioned i.e. data transparency and risk retention, we view as being of a smaller magnitude in the overall equation.
    b. Overly punitive capital requirements for the ABS dealer community will also undermine liquidity within the market which bodes unfavorably for issuers.
    c. In terms of the rating agencies representing an impediment to the ABS market, we view such features as country rating ceilings and ancillary facility ratings to some extent as independent of the underlying credit risk encompassed in ABS deals. We realize that this is something which can only be addressed by the rating agencies themselves and would not envisage this to likely be resolved in the future. Again as capital requirements for investors are heavily based on external ratings within the current system, this (in particular for peripheral issuers) represents a significant barrier to entry to the market.
4. Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

    a. We view sufficient market liquidity as necessary to broaden the investor base and hence issuers are better able to place new issuances on an ongoing basis with the investor community.
    b. Furthermore, liquidity is essential to attract investors to a well functioning market where they are assured of being able to exit investments at any time.

MEAG

5. The view of the Bank of England and the ECB is that a '**qualifying securitisation'** should be defined as a security where **risk and pay-offs can be consistently and predictably understood**. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?
    a. We deem the definition as outlined above as acceptable. Bearing in mind that investors should be reminded that this definition makes no reference to credit risk of a given transaction (i.e. not to be misconstrued as a risk free investment).
    b. We gather that the "qualifying securitization" label shares significant overlap with the PCS Market initiative and ECB eligibility criteria already in place. However, encouraging a common standard across all investments would be beneficial in our opinion.
    c. We to some extent would not only view true sale (Box 3 No. 130) but also synthetic risk transfer to an SPV potentially as a qualifying securitisation if transparency and comparability of the underlying pool as well as clear documentation are given e.g. PROMISE, PROVIDE

6. Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?
    a. We do not agree, that a "qualifying certification" by itself will significantly increase liquidity. One important requirement for a liquid market is a decent number of participants and/or market makers, that are able show two way levels. We believe that as long as regulatory treatment is relatively punitive for ABS compared to other asset classes, entry barriers for banks and insurance companies will remain high.
    b. If the qualifying certification would however be counted towards and result in lower capital charges due to a conform underlying quality (more aligned with for instance covered bonds), then we would inadvertently anticipate this to lead to a more liquid market.

7. These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?
    a. It is questionable in our opinion how a framework could be put into practice as this would potentially require a certain authority which classifies and designates the "qualifying securitization" to any given security (i.e. who officially determines what is deemed qualifying or not?)
    b. A European Securitization framework acting as an "independent authority" to rule over standards (prospectus standards, loan by loan disclosure etc.) might be important here in our opinion. The PCS Association certainly has set a starting point, however more

stringent and binding standards have to be established. A legal framework would undoubtedly be binding for all. Beyond the clear definition of standards, such European legislation would send a strong systemic message to investors, regulators and issuers, that securitization has no longer any stigma effect. Such legislation could also potentially function as trigger to abolish the current punitive regulatory treatment. Given such legislative framework we would also have guidance in differentiating ABS backed securities from covered bonds, which is always requested by the CB industry.

c. A risk we perceive here is that some transactions may potentially no longer be treated in the same way as others which would unlikely help the ABS market overall but rather benefit these certain transactions. CLOs for instance demonstrate good performance historically (with predictable pay off and risks) but would in all likelihood not be awarded the quality seal. Therefore we would appreciate a framework for CLOs to become 'qualified securitisations'.
d. It is also vital to consider the importance of outstanding transactions within the ABS market, which leaves the question as to how potentially these would be qualified without leaving a two tier regime with consequent treatment (primary vs secondary)
e. We would recommend to focus on transparency requirements (initial data, ongoing data etc) to reduce asymmetric information and to support standardization, instead of using pre-defined and specific asset classes.

8. Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?
    a. We deem it very much crucial to have current, timely and accurate data for underlying holdings. Transparent and high quality data which is conform across transactions simplifies the analysis as well as ongoing surveillance for Investors, which would greatly benefit from a harmonization within the securitization market.
    b. For the majority of liquid (plain vanilla) ABS, the data availability has definitely improved over time (especially the transaction which already conform to PCS and ECB eligibility). We think the focus should lie on improving reporting standards for less plain vanilla transactions and achieving more standardization (e.g. CLOs/CMBS)
    c. We feel that whereas reporting may have improved it is still lacking clarity as to how certain numbers are derived or calculated in individual reports. This complicates a transparent comparison between individual deals. We think a clear clarification in this respect would greatly benefit investors.
    d. Also the comparability of ABS across different jurisdictions still remains a problem and efforts should be made to increase the conformity across countries in reporting standards.

9. Do respondents think that initiatives currently undertaken by authorities in the area of **standardisation of prospectuses** and **investor reports** and **trade transparency** are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardized investor reports in a single location be helpful to securitisation markets?
    a. The current initiatives (such as PCS) are already improving reporting standards and transparency, however this does not necessarily encompass all transactions which we see as failing to help the overall ABS market to some extent.
    b. We would very much welcome a centralized location for data and standardized investor reports available to ALL potential investors. Standardized investor reports would be very helpful for ongoing deal surveillance and deal comparison.
    c. Trade transparency would be beneficial however we believe with differing modeling assumptions by individual market participants, prices will naturally to some extent diverge for specific ABS transactions.

10. Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?
    a. We think this heavily depends on individual jurisdictions with some countries' confidentiality laws being more liberal than others. Obviously the information would be indeed helpful for investors to judge historical credit behavior and performance, but we just see this as very difficult to implement across different European transactions.

11. In order to aid performance measurement and to provide investors **with industry-level data**, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?
    a. We do not feel as though macro economic data should be required to be disseminated by ABS issuers, as we already benefit from the independent macro research of individual banks covering us and more importantly our own in-house research capabilities.
    b. Transaction specific Loan level data is in our view one of the most important sources of information for a detailed analysis which is unfortunately still hard to attain and we actively push for issuing banks to provide this along with all other information.
    c. Challenges: In order to efficiently process the loan level data, investors need to be sophisticated enough to model the data given i.e. have the necessary data systems and know how in place.

12. Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?
    a. In our opinion this may be premature, as the focus should lie on reviving the ABS primary market first.
    b. The market would potentially benefit from an ABS index in terms of being able to hedge positions and consequently smooth out market swings and volatility on underlying trades. It would also help make performance measurement more transparent. Benchmarks might also be helpful for risk management (i.e.monitoring)
    c. A risk for ABS indices would be that Investors would mainly use this to outright short a market (as witnessed in the US with the ABX and CMBX indices) which could amplify problems in a downward market.

13. Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?
    a. The additional information would probably help investors view the agencies risk perception for just the underlying credit risk (similar to shadow ratings used for wrapped bonds in the past). But if this rating would solely be for information purposes and have no validity in either regulatory capital or internal systems, we think it would not have a great impact on liquidity.

14. How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?
    a. We view this as important, however again this is a rating agency issue for which the final decision will lie with the rating agencies. The proposal of loosening criteria on this in order to make available a wider range of counterparties (for swaps/liquidity facilities and GIC accounts) will inevitably have to be accepted by the rating agencies and their current modeling approach. We could not possibly comment on the costs of SPV bank accounts falling outside the insolvency estate.

15. With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?
    a. We do not have any additional points in this regard.

16. Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?
    a. We believe that a less levered investor base and the exclusion of Re-Securitiasation and certain synthetic transactions (lack of comparability to underlying well-diversified pool e.g. CSOs, index derivatives, CPDOs) as outlined are desirable in order to support the emergence of a robust securitization market.
    b. We view very negatively the proportionally exponential capital charges for ABS in conjunction with longer maturities of assets. If the ultimate aim is to alleviate the funding problem for SMEs this will have an overly punitive effect on smaller companies which require funding on the long end of the credit curve which is inaccessible to them in the current environment.

17. Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?
    a. In our opinion any attempt to create another way of achieving the benefits associated with ABS would most likely result in even further complexity and the focus should lie on re-establishing a fully functioning securitization market rather than spawning a new product.

18. Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?
    a. In terms of the envisaged data transparency and standardization of Reporting, we believe that this will lead to more precise and accurate risk assessments.
    b. We do not see any unintended consequences in having more high quality data available to Investors.

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THE CASE FOR A BETTER FUNCTIONING SECURITISATION MARKET IN THE EUROPEAN UNION

Moody's Investors Service ("MIS") appreciates the opportunity to provide comments to the European Central Bank ("ECB") and Bank of England ("BoE") on the discussion paper: *the case for a better functioning securitisation market in the European Union* (the "Paper").

Following the publication of the Paper, MIS published a special comment titled "*The Revival of the European Securitisation Market, Overcoming the Barriers*" [1]in which we welcomed the support shown for the structured finance market and noted that various barriers still exist to further growth in the sector. In addition to the above special comment, MIS published a special comment that supported the assertion in the Paper that European securitisation largely performed according to expectations during the crisis, especially given the real economic stress across the region.[2]

This response draws on the content of the special comments referred to above and in addition we specifically address two issues raised in the Paper:

1. Sovereign ceilings; and
2. The concept of "qualifying securitisation".

In Annex I, we have responded to some of the individual questions posed in the Paper.

[1] https://www.moodys.com/viewresearchdoc.aspx?docid=PBS_SF370538

[2] In particular, MIS noted that despite the 2009 global downturn and the recession affecting many European countries, none of the senior notes in EMEA asset-backed securities (ABS) or residential mortgage-backed securities (RMBS) rated Aaa (sf) by MIS incurred, or are expected to incur, principal losses. Overall, less than half a percent of all of the EMEA ABS and RMBS notes rated by MIS have realised a principal loss, and only 2% are still likely to incur a loss. For a more detailed analysis on the performance of European ABS and RMBS, see Moody's Special Comment: *European ABS and RMBS: Historical Resilience Will Continue Beyond 2014*. https://www.moodys.com/viewresearchdoc.aspx?docid=PBS_SF367681

1. **<u>Sovereign ceilings</u>**

The Paper suggests that the imposition of structured finance credit rating caps on ABS "has had a negative impact on the securitisation market in certain EU countries where it is no longer possible to achieve a triple-A rating" and that this "may undermine transparency around the inherent credit quality of securitisations". We believe that the interests of the credit markets are best served by ratings that aim to capture all credit-related risks, including risks captured by Local Country Ceilings ("sovereign ceilings").

In our view, all debt issuers, including securitisation vehicles, are exposed to some level of unavoidable risk simply because they operate in a given environment. The nature and level of that risk will depend on the environment. In the EU, sovereign ceilings primarily reflect the very low probability but high impact economic and financial consequences of a disorderly sovereign default which, for euro area issuers, include the possibility that default is accompanied by euro exit and currency redenomination. Sovereign ceiling risks are difficult to assess objectively. Ceiling events are, by their nature, very unlikely to occur. That said past instances of sovereign default illustrate the severity of such an event for all domestic issuers. In the euro area, the rising probability of a Greece exit from the EU and increased currency redenomination risk on outstanding debt issued by Greece would have created severe losses for investors in Greek debt. This was a real foreseeable risk. There is little reason to think that events would differ dramatically were the sovereign to default again.

Ceiling risks therefore cannot be ignored, even if estimating them involves highly qualitative judgments. We do not believe that either diversification or credit enhancement allows structured finance transactions to fully mitigate such risks. No issuer can be more diversified than the sovereign, and risks such as capital controls, currency redenomination or interference in transactions through regulation or legislation cannot be eliminated with higher levels of credit enhancement. We do not think that the view that very high levels of credit enhancement could justify Aaa ratings is the basis for a systematic rating system. For that reason we apply a rating cap – the sovereign ceiling – at the point at which ratings can no longer meaningfully differentiate between degrees of credit risk, and cannot properly express certain country risks. Far from undermining transparency around the 'inherent' credit quality of transactions in certain jurisdictions, we believe that sovereign ceilings allow us to offer investors a richer view of credit risk in each environment.

Equally, we recognise that not all market participants share our view of country risk, and that some investors find it helpful to understand what the credit rating would have been at the closing of a transaction were the sovereign ceiling not capping the rating. In other words, what might the initial ratings be if not impacted by the current sovereign ceiling. MIS has recently published a report "Updated Sensitivity Analysis Clarifies How Sovereign Risk Affects Structured Finance Ratings" which is intended to provide investors with additional information on structured finance ratings and which may address some of the concerns expressed in the Paper.[3] In this report, MIS sets out how it will make this information available to the market through an adjusted parameter sensitivity analysis which will indicate the upgrade or downgrade potential of a newly issued structured finance rating as a direct result

[3] www.moodys.com/research/Updated-Sensitivity-Analysis-Clarifies-How-Sovereign-Risk-Affects-Structured-Finance--PBS_SF368089

of neutralising the sovereign ceiling. These parameter sensitivities provide a quantitative, model-indicated calculation of the number of notches that a MIS-rated structured finance security may vary if certain input parameters used in the initial rating process differed.

As an example of how this is applied in practice:

MIS assigned a provisional rating of A2 to the highest tranche of MARS 2600 Series V (Prime RMBS/Italy). The table below shows the sensitivities for the transaction rating if the LCC and the servicer rating were different:

Servicer rating				
		A1	Baa1	Ba1
LCC	Aaa	Aaa	Aaa	Aa2
	Aa2	Aa2	Aa2	Aa2
	A2	A2	A2	A2

Therefore, if the sovereign ceiling was Aaa and the servicer rating was anything at or above Baa1, *ceteris parabus*, then the tranche could have achieved a Aaa rating.

This additional information to be provided on all new structured finance transactions in the EU, where the relevant sovereign ceiling is below Aaa, will provide users of our ratings with an understanding of the maximum achievable rating were it not capped by the sovereign ceiling. We have noted that the ECB and the BoE have suggested that CRAs include such information in rating reports and we are pleased that the central banks see our efforts as a useful contribution to increased transparency in the capital markets.

2. **The concept of "qualifying securitisation"**

2.1 Factors that MIS considers as contributing to uncertainty in forecasting credit risk

The Paper highlights a number of proposed principles that are considered necessary for a securitisation to constitute a "qualifying securitisation". MIS understands the benefit such a classification may have for the ECB and BoE, particularly in regard to the predictability, certainty and level of assessment of the risk. MIS considers similar factors when performing a relative assessment of the quality of available credit information and the potential variability around the various inputs to a rating determination. The level of uncertainty around the shape of the collateral pool's potential loss distribution and the resulting impact on the ratings of structured finance securities depend upon a variety of factors, including the sector/issuer historical performance variability, the quality and quantity of the data used in the analysis, the complexity of the collateral and the transaction's structure, and the robustness of transaction governance.

These factors form the basis of an opinion about a transaction's exposure to factors that contribute to uncertainty in estimating credit risk and which could give rise to ratings volatility. This opinion is determined based on an analysis of:

1. *Sector Historical Data Adequacy and Performance Variability*: The length and quality of the sector's historical performance data (including our view as to the extent to which historical data is likely to signal probable future performance), as well as historical performance variability and the sector's average downgrade rate compared to corporate securities;
2. *Issuer/Sponsor/Originator Historical Data Adequacy, Performance Variability and Quality of Disclosure*: The length and quality of historical performance data for the issuer, sponsor and originator; issuer, sponsor and originator's historical performance variability; and the extent, timeliness and quality of disclosure of collateral characteristics and securitisation remittance reporting;
3. *Complexity and Market Value Sensitivity*: The complexity of the transaction (both asset and liabilities) and the level of exposure to the market value of the underlying assets; and
4. *Governance*: The experience and oversight of transaction parties, the alignment of interests among transaction parties, the adequacy of the back-up servicer arrangement (involving a consideration of the probable need for a servicer transfer and potential challenges in effecting such a transfer), and the level of legal and regulatory uncertainty – based on both historical precedent and the current environment – about the responsibilities and rights of the key parties.

2.2 Two essential factors for any "qualifying securitisation"

In order to assist with the determination of the above factors and to reduce the uncertainty these factors may create, there are two areas where we, as users of the information flowing from securitisations, would benefit from further policymaker intervention. These are:

- Transparency, comparability and quality of data; and
- Legal certainty around the securitisation structure.

Taking each of these in turn:

2.2.1. Transparency, comparability and quality of data

The Paper correctly mentions that "data availability has improved in various jurisdictions post-crisis" but that asset data and performance monitoring metrics "have been inconsistent across deals". As MIS uses financial data published by issuers as one of the key inputs for its credit analysis, we welcome regulatory initiatives focused on increasing the frequency, quality and consistency of publicly available information. In particular, MIS supports the ECB and BoE loan level initiatives. In addition, MIS looks forward to the implementation of Article 8b of Regulation (EC) 1060/2009[4] and the creation of the website by the European Securities Markets Authority ("ESMA") relating to information on structured finance instruments.

[4] Article 8b (1) states that "the issuer, the originator and the sponsor of a structured finance instrument established in the Union shall, on the website set up by ESMA pursuant to paragraph 4, jointly publish information on the credit quality and performance of the underlying assets of the structured finance instrument, the structure of the securitisation transaction, the cash flows and any collateral supporting a securitisation exposure as well as any information that is necessary to conduct comprehensive and well-informed stress tests on the cash flows and collateral values supporting the underlying exposures."

These initiatives allow detailed, consistent information about underlying credit risks to be provided by issuers to the investing public which in turn increases the diversity of opinion and level of debate and improves the functioning of markets.

However, information disclosure is only the foundation of an effective market discipline framework. Enhancing the disclosure regime for issuers so that detailed, *consistent* quality information about underlying credit risks is provided by issuers to the investing public is important. Information should be disclosed at regular intervals or periods and in a consistent and standardised format that allows for comparability and be of sufficient quality that allows users of the information to rely on the information without an additional verification process. Currently, there is no standardisation with regard to terminology and calculations for ratios and triggers in the EU securitisation market.[5] Furthermore, the definitions in the various transaction reports are often unclear or inconsistent. If definitions are not clearly provided, it is difficult for investors to ensure consistency of analysis across transactions and benchmark them appropriately. It is therefore imperative that all the terms are clearly defined in the investor report and detailed formulae are provided for ratios and triggers to ensure accurate monitoring analysis.

Improved data transparency together with standardisation would make transactions easier to analyse; an additional benefit is that investors would be better able to compare the characteristics of a securitised loan pool against those of the loan book of the respective originator.

2.2.2 Legal certainty around the securitisation structure

A key component in determining the level of risk in a securitisation is whether the legal system provides certainty and an understanding of the implication of legal outcomes. Although we recognise the challenges associated with the establishment of a harmonised legal system across the EU, the structured finance market would benefit from greater efficiency and transparency where a clear and consistent legal framework *for transaction structures* could be developed across jurisdictions.

This legal framework, which should include standardised terminology and documents, should not be limited to rules and regulations on the transaction surrounding the securitisation. Areas such as true sale, title to ownership, insolvency and bankruptcy provisions should be well established, clear and consistent. A harmonisation of the legal framework would not only reduce legal risk but would also allow for greater comparability of transactions.

An additional benefit of the two policy objectives above is that with a more certain legal environment and disclosure framework, potential barriers to the availability of transaction counterparties are reduced. Such a framework would reduce the risk of, and allow for, an easier interchange of transaction counterparties.

[5] For example, there is currently no consistency with regard to the delinquency definition across transactions. Some transactions report delinquency based on the number of days delinquent independent of the amount unpaid, while others report delinquency based on the ratio amount unpaid divided by the contract monthly obligation. Some transactions report defaulted loans and repossessed loans in the late stage of the delinquency bucket, while others report these loans separately.

For further information on the above and to address some of the specific questions in the discussion paper, please see Annex 1.

We trust that you will find our comments helpful and would be pleased to discuss our views with you at your convenience.

Yours sincerely

Katherine Frey

Managing Director EMEA Structured Finance

ENCL.

ANNEX 1: QUESTIONS FROM THE DISCUSSION PAPER

QUESTION 1: Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?

Moody's believes that an increase in the issuance of European securitisations will provide a long-term funding source for SMEs and consumer borrowing which, in turn, should stimulate business investment and household consumption and hence economic growth. Furthermore, the resumption of a strong structured finance market will allow for a broader distribution of credit risk among financial institutions and third-party investors, helping to reduce the accumulation of risk on banks' balance sheets.

QUESTION 2: Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?

As set out in our Special Comment[6], Moody's broadly agrees with the impediments identified by the BoE and ECB. First, the securitisation market has yet to replace the exits of a large segment of formerly active investors. Second, the anticipated regulatory costs imposed on the remaining EU investors (when compared to other asset classes, particularly covered bonds) also diminishes the pure economic attractiveness of the product for both investors and originators (as we set out in answer to question 3 below). These costs are perceived by some to be both punitive (particularly compared to the treatment of other asset classes), complex and, given the pace of change, uncertain. Third, the infrastructure costs of investing in securitisation are relatively high; a particular barrier for smaller investors.

QUESTION 3: Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?

Regarding additional impediments, MIS believes that the slow macro-economic recovery across the euro area is affecting loan origination. This factor, combined with the continued balance sheet evolution of many EU banks, limits the volume of underlying assets available to be securitised. There is also a tension between providing investors with the return they appear to require given perceptions of financial risk (as well as regulatory costs), and the interest rates that can be charged to borrowers. This is likely to be particularly constraining the securitisation of SME assets, for which the information asymmetry between originator and investor is widest and therefore the risk adjusted returns required by investors make securitisation an uneconomic way of funding bank lending to SME obligors. The cost, complexity and volatility in regulation is as much a barrier for issuers, as for investors, with the inconsistent treatment of securitisation across jurisdictions.

[6] 'The Revival of the European Securitisation Market, overcoming the Barriers.'

QUESTION 4: Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

MIS has no comment.

QUESTION 5: The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

Please see section 2 in the cover letter.

QUESTION 6: Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?

MIS has no comment.

QUESTION 7: These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?

MIS has no comment.

QUESTION 8: Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level date be improved, so that it provides most value to investors?

Please see section 2 in the cover letter.

QUESTION 9: Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?

MIS has no comment.

QUESTION 10: Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?

MIS believes that market access to credit data would be beneficial to the securitisation market. If we take the case of SMEs, data from Corporate Credit Registers (CCRs) allow originators to better monitor the financial situation of, and thereby facilitate lending to, SMEs. [7] The use of enhanced CCR information improves credit assessment at origination, and allows for more effective servicing, with higher recoveries on defaulting loans. There have been recent enhancements aimed to improve the amount and quality of data available from CCRs of different European countries. This should include reporting in a standardised and consistent way – not only at the inception of the deal, but also on an ongoing basis during the life of the transaction.

QUESTION 11: In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

With respect to lending/performance data, there is insufficient standardisation of definitions and terminology which means that banks do not report in a consistent way. This results in data not being comparable across entities. It would be helpful to the market if, for example, SME lending amounts (along with detailed breakdowns such as geographical/sector/etc) and comparable performance measures (e.g. 90d+ delinquencies) were published by banks. This would allow investors to compare the characteristics of a securitised loan pool against those of the loan book of the respective originator.

QUESTION 12: Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

MIS periodically publishes indices for RMBS, and ABS transactions (consumer, lease and SME).[8] These indices include data such as delinquencies, cumulated defaults and prepayment rates, as well as different breakdowns by geographical areas, originators, etc. By reviewing the indices, market participants can compare the performance of a particular transaction relative to similar transactions within its sector. The indices provide metrics (e.g., delinquencies, latter-day delinquencies, recoveries, cumulative losses and selected macroeconomic data) that allow for comparisons with asset classes.

QUESTION 13: Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

Please see section 1 in the cover letter

QUESTION 14: How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the

[7] See MIS Sector Comment: National Corporate Credit Register Data Enhancements are Credit Positive for European SME ABS Transactions (https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_SF332667).
[8] See for example the March 2014 EMEA-ABS-SME loan and lease indices below: https://www.moodys.com/research/EMEA-ABS-SME-loan-and-lease-Indices-March-2014--PBS_SF367298.

originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

In principle, legal solutions which would safeguard SPV accounts should the originator or servicer become insolvent would be credit positive. In practice, MIS's experience is that originators prefer to retain bank accounts even when the credit profile of the account provider would not make them eligible according to the original transaction documents. Any solution would need to take into account both the credit, liquidity and operational element of bank account disruption. In particular, it is necessary to ensure that not only cash would be finally available for the SPV but that there would be no disruption in the availability of cash on a daily basis. This would also require adequate operational provision with third party involvement. Any standardisation of counterparty roles would also facilitate the fungibility and replacement of back-up solutions.

QUESTION 15: With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?

MIS has no comment.

QUESTION 16: Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

MIS has no comment.

QUESTION 17: Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?

MIS has no comment.

QUESTION 18: Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?

Please see section 2 in our cover letter.

Although MIS has no opinion on the appropriateness of the proposed qualifying criteria, we would note that there may also be negative consequences that may result from establishing fixed criteria for a 'qualifying securitisation' in that it may limit innovation and the ability of the market to respond to changing needs. This is particularly pertinent given the objective of the authorities to see an increase in the funding of SMEs via securitsation. For example, the requirement to assign all security interests appears to conflict with the business practices of number of banks in using 'all-monies' charges. These charges link a single security package with all the loan facilities that exist between a bank and its customer; a clear a barrier to originators complying with the provision to assign all security to and SPV, if it were not also assigning all the relevant loan facilities.

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SUBMITTED BY EMAIL

4th July 2014

Dear Sir or Madam

A DISCUSSION PAPER PREPARED BY THE BANK OF ENGLAND AND EUROPEAN CENTRAL BANK STAFF: THE CASE FOR A BETTER FUNCTIONING SECURITISATION MARKET IN THE EUROPEAN UNION (THE "PAPER")

Nationwide Building Society ('Nationwide') welcomes the opportunity to respond to the Bank of England and the European Central Bank joint discussion paper on a better functioning securitisation market in the European Union (the 'Paper') in its capacity as both issuer of and investor in securitisations.

Nationwide is the world's largest building society, one of the UK's largest savings providers and a top-three provider of mortgages, with circa £190bn in assets. Nationwide is a market leader in providing banking services but we are not a bank – we are a mutual building society: Nationwide is owned by and run for the benefit of our 15 million members, who include our retail savings and mortgage customers. As such we are unique in UK retail financial services, providing a credible alternative to the plc banks and focusing on long-term, transparent customer relationships. Whilst our core business is residential mortgage lending funded by retail deposits, we are a full service personal finance provider, offering current accounts, personal loans, credit cards, investments and insurance.

The principles on which we are run are fundamentally different to those of our plc peers – we exist to deliver value to our member customers and we are accountable to them. We are able to optimise profit – rather than maximise profit – to deliver member value over the longer term through improved pricing and market-leading customer service. This results in a lower risk appetite and profile than that of our peers meaning we have remained safe and secure throughout the financial crisis with capital and liquidity ratios amongst the highest in our peer group.

In the year ending 4 April 2014, Nationwide advanced £28.1bn of mortgages - a market share of 15% - and our net mortgage lending was up by 52% to £9.9bn. We continue to account for over 20% of all new first time buyer mortgages. We target between 20-25% of our funding from wholesale markets, meaning that efficient access to secured funding is critical to our lending activities in the real economy.

As an issuer, Nationwide has been sponsoring a UK RMBS Master Trust since 2008. Our only motivation in operating this securitisation programme is funding. To date, we have chosen to distribute only AAA rated securities, and the pool underlying the programme is a random selection of eligible prime UK 1st charge owner occupied mortgages underwritten by Nationwide. All of the economic risk and reward of the programme remains substantially with Nationwide, and we have neither sought nor been granted any regulatory capital relief from the underlying assets which remain on our regulatory and accounting balance sheet. As such, capital held by bank investors in this programme is incremental to, and not in place of, capital held by Nationwide as originator of the underlying mortgages.

Key Comments

Nationwide is a strong supporter of reviving, protecting and promoting securitisation in our capacity as both issuer and investor. As such, Nationwide is a member of the Prime Collateralised Securities ("PCS") initiative, an industry initiative which aims is to reinforce asset-backed securitisation as a sustainable investment and funding tool, improve market resilience in Europe, and promote growth in the real economy. To assist with its objective PCS labels securitisations as "High Quality Securitisation" if they meet the PCS criteria.

Nationwide fully supports the need for a structured framework around "qualifying securitisation" within Europe. However we are concerned that this initiative alone will not protect the securitisation market unless the penal capital requirements proposed under Basel III and Solvency II are modified. Any "qualifying securitisations" should be treated in a manner which is reflective of the true nature of their risks and is comparable to the treatment of similar assets. A recent analysis noted that "It is striking that the average volatilities for each of the geographical regions [for securitisations] are lower than the corresponding average for Covered Bonds. This finding is in stark contrast to the favourable regulatory treatment that Covered Bonds receive in Europe."[1] Our concern surrounding the excessive capital requirements proposed is the likely reduction of investment in securitisation which would cause us and potentially other issuers to have to resort to more expensive funding through other methods (the cost of which is ultimately reflected in the cost to the consumer) or potentially reduce our ability to lend. Nationwide also makes discretionary investments in high quality securitisations to meet internal and regulatory liquidity requirements.

Questions:

1) **Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?**

   We agree with the benefits outlined in section 2. As investor (and in common with many other treasuries) Nationwide invests in established ABS markets primarily to support secondary liquidity requirements but also as part of its discretionary investment activity. As an issuer, Nationwide typically seeks to fund between 20-25% of its balance sheet via the wholesale markets and securitisation funding provides a critical role in meeting this funding requirement across each year of our five year corporate plan going forward.

2) **Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?**

   We agree with the points identified. As an investor we would particularly highlight that the currently regulatory uncertainty is the main overriding impediment – it is difficult to invest without knowing how the investment will be treated for capital and liquidity purposes.

   An additional impediment we have experienced recently is in relation to using the Bank of England's ILTRO. Several high quality Dutch prime RMBS which were on the list of eligible securities were deemed ineligible on the ground that the transaction level data was not available on the originator's website, despite being publicly available elsewhere.[2] It would be helpful if a more inclusive approach were adopted which does not require RMBS data to be available in one specific place, but only that it is publicly available through an industry-wide accepted portal.

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[1] High Quality Securitisation: An Empirical Analysis of the PCS Definition by William Perraudin Risk Control Limited 20th May 2014 – Page 27 Section 6 – Comparisons with Covered Bonds. William Perraudin is a Director of RCL and Adjunct Professor of Imperial College.

[2] The securities are also PCS labelled.

3) Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?

Yes. The impediments in the form of inappropriate capital treatment in different regulations comprise the most significant impediment. In addition, we would highlight the following:

a. We welcome the comments made in para. 89-90 regarding the current reliance of the market on credit rating agencies ("CRAs"). This could be reduced by stimulating competition through improving transparency on rating agency criteria and by encouraging rating agencies to disclose the implied transaction rating based on counterparties meeting the minimum required rating. [3]

b. Penal swap counterparty criteria introduced following the crisis. CRAs have introduced collateral add-ons ("volatility buffers" or VBs) which have introduced additional costs to transactions whilst at the same time making these swaps less easily replaceable and more expensive to replace in the event of counterparty default. Widespread downgrades of swap counterparties has meant that collateral posting has become the norm for transactions. The additional collateral required to be posted to meet the VBs creates additional liquidity costs for issuers whilst also increasing the SPV's credit exposure to the swap counterparty. The additional collateral also unnecessarily increases the securitisation SPVs' credit exposure to the account bank holding the cash collateral as the collateral may need to be transferred to another institution if the account bank is downgraded. We explore potential solutions to mitigate this further in response to question 14 below.

d Regarding para. 92 "Cost pressures" we have not observed this, as the market is still reliant on ratings.

4) Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

We agree that in theory low market liquidity could be a barrier to a well-functioning market. Currently however we think that it is impossible to judge the true liquidity of the securitisation market because this market is currently dislocated. This is primarily due to the impediments that exist in the form of impending regulatory changes which threaten to impose punitive capital requirements on securitisation investments but also due to the effect of sovereign credit rating caps. With an appropriate regulatory environment, we think that the level of liquidity in the securitisation markets could be improved. In this respect, an impediment to liquidity is the limited value that securitisation bonds are given as an eligible asset for banks' liquidity buffers. In this respect we recommend that 1) a wider range of securitisations is made eligible for inclusion in the LCR buffer and 2) qualifying securitisations should be afforded treatment which reflects their true risk profile and is closer to the preferential treatment of similar assets.

With regard to the LCR buffer, we are very concerned by the current exclusion of revolving securitisations as this threatens to exclude the largest, highest quality and most liquid transactions, including that of our own Silverstone Master Trust. Whilst proposals are in circulation to amend this, we think it important to underline the necessity of changing this provision given the September 2014 deadline. Otherwise the LCR will exclude all RMBS

[3] We discuss this solution in more depth in our response to the ESMA discussion paper dated 10/07/13 regarding implementation of the CRA Regulations Regulation (EC) No 1060/2009 and Regulation (EU) No 462/2013.
- see http://www.esma.europa.eu/system/files/nationwide_building_society_complete_0.pdf.

issued by UK master trusts – i.e. the RMBS issued by the UK's largest mortgage lenders. In addition, we propose that ABS backed by residential loans made to landlords should also be made eligible as these relate to the real economy and have also exhibited strong performance. The delegated act implementing the LCR is no longer open to public consultation so the industry is reliant on governments and regulators to assist the EC in arriving at an appropriate outcome that supports securitisation.

Another point we wish to highlight is that the securitisation market benefits from the convention of issuing public "BWICs". A BWIC is a public solicitation of "Bids Wanted in Competition" for a specified notional amount in a named security. Whilst this is not used for every trade, where it is used, it does create a good level of transparency in comparison to trade information available for other fixed income markets.[4]

Regarding para. 93 and footnote 9, we observe that it may not be appropriate to measure liquidity in securitisation bonds by volume of trading in individual securities. This is because many investors in this market are buy and hold investors which means that securities may be liquid without being frequently traded. Liquidity in such cases should be judged by the liquidity of securities of the same name or asset class – e.g. bonds issued under the "Granite" programme may be liquid as a class even though some individual tranches of Granite bonds may not have traded or traded frequently.

In terms of primary distribution and primary liquidity, in our experience the securitisation markets proved to be a critical source of funding in the aftermath of the financial crisis when other markets were unavailable. For example Nationwide was able to complete a publically distributed securitisation in October 2009 at a time when raising funding in other markets was challenging. A key reason why investors were willing to invest in securitisation during such market turmoil is its unique feature as an investment, i.e. that it is entirely independent and self-standing, structured to be capable of being repaid solely from contractual cash flows of the underlying assets. Thus the credit quality of ABS is less tied to credit events affecting the standalone strength of the originator than other debt, including covered bonds.[5] Given some of the advantages of securitisation over other investments, we consider that the true value and liquidity of securitisation instruments has been under-estimated by regulators in some quarters. In the research we have received, we have not seen a study which performs a walk-through analysis of the financial crisis reviewing the quarter by quarter primary and secondary activity for the range of fixed income instruments over time and think it could it be beneficial for any QS task-force to consider requesting this.

5) The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

In principle, yes. Subject to the suggestions put forward in this letter and of course reviewing exactly how such a concept is to be used in practice, we are very supportive of such a 'qualifying securitisation' concept being adopted as an industry wide definition in all relevant regulations with any changes this entails.

In particular, we agree with the proposal in paragraph 19 that the principles for 'qualifying securitisations', should be applied to an entire transaction and not to individual tranches. We believe that an inclusive definition of "qualifying securitisation" which includes all

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[4] However, the BWIC process is not perfectly transparent as only the cover price and not the final trade price for a transaction is disclosed – we address this point in our further answer to Q9.

[5] Investors Twenty Four Asset Management published an article comparing the relative performance of Co-operative Bank debt and found RMBS to demonstrate the strongest price and ratings stability – see further http://www.twentyfouram.com/blog/highlighting-strength-rmbs-vs-bank-debt-co-op-bank.

tranches is the correct and appropriate approach since all tranches of a given securitisation benefit from the collateral and structural features identified in box 3. It follows that the regulatory treatment and associated capital requirements attaching to any "qualifying securitisations" should attach to all tranches of the securitisation as a whole.

We do not suggest that all tranches of a securitisation should always receive the exactly the same treatment in every regulation in which the "qualifying securitisation" identifier is adopted – e.g. junior tranches should still attract higher capital charges than senior tranches – but simply make the point that any regulatory lines drawn which reference the "qualifying securitisation" concept should apply to the securitisation as a class of securitisation and encompass all tranches whilst at the same time being risk sensitive within this where appropriate.

There are a number of proposals in circulation which seek to set a framework regarding the sort of securitisations which should be encouraged. For example, the independent securitisation labelling initiative PCS currently has a framework under which only the single most senior class of a securitisation is eligible for a label. However the authors have a far broader remit than the current PCS remit. With this broader remit in mind, we support the development of a "qualifying securitisation" ('QS') concept subject to the comments and concerns outlined in this letter and reviewing how the QS definition is used in specific cases or regulations.

Regarding specific issues outlined in Box 3, we agree with paragraph 125 that one of the key weaknesses in the securitisation market that existed prior to the crisis was the ability for participants to create securitisations without retaining any "skin in the game" and that this has been cured via specific legislation on risk retention.[6]

Para 130 seeks to rule out securitisations with derivative-linked claims i.e. synthetic securitisations. Whilst this does not directly impact our current activity, we think that in principle it is possible for a synthetic securitisation of real economy assets such as residential mortgages to be simple, transparent and facilitate funding for the real economy in a very similar way to a full securitisation of the same assets and as such, if appropriately defined, we support such securitisations being included within QS.

We assume the intention under paragraph 135 around perfection of interest is in keeping with current practice of equitable transfer which is the method by which true sale is effected under English law. If this is not the case, we recommend this point is reconsidered as changing the current practices around perfection of interest via a legal transfer would not provide the investor with any additional protection.

Regarding paragraph 132 and 134, we think that residential mortgages made to landlords are another example of underlying assets which should be eligible for qualifying securitisations. In addition, our view is that CLOs are also potentially another class which could be included in QS. Like SME securitisations, CLOs are used to fund real economy loans and as an investor, our experience of investing in high quality CLOs has been very positive with no losses. We continue to include CLOs as one of the narrow range of investments we invest in.

With regard to para. 144, we question whether the requirement that the securitisation be subject to ongoing ratings by two ECAIs is consistent with the stated aspiration of Regulation (EU) No 462/20131 of removing references to credit ratings in all European legislation by 2020. We suggest that this requirement be either removed or reduced to one.

We think that it is possible for the market to evolve to a point where reliance on ratings is reduced and/or an evolved form of rating becomes market standard. We think that this objective could be achieved in part through increasing and refining disclosure of the credit

[6] Given the strong performance of European consumer securitisations through the crisis, this legislation has corrected an issue that was more problematic in US securitisations than in the UK or Europe.

elements comprising a transaction. For example, investors often ask lead managers for first loss stress information ahead of investing in a transaction. If market practice was to disclose such information in all qualifying securitisations this might reduce the need for investors to rely on external ratings and it is possible that a number of examples like this could have the cumulative effect of reducing reliance on external ratings in general.

Another example is historical loss performance data which investors use to model stressed transaction scenarios. Whilst (at least in the world of RMBS) this information is often embedded in data that is already currently disclosed, investors are still reliant on either their own modelling or third party modellers (such as Intex or ABSnet) to collate this information over time from investor reports to be able to calculate constant default rates ('CDRs'). Notwithstanding the additional potential expense for ourselves, we think it would be helpful if the process for deriving this information was simplified and originators presented annual loss rates in a simple table. This would not be a substitute for investor analysis but would at least be available for the purposes of comparing with the loss rates calculated by investors and third party modelling services.

Furthermore, it could potentially enhance transparency if bank and building society originators of securitisations uniformly disclosed the level of internal capital held against the pool prior to securitisation, as 1) this information could be used by investors in conjunction with data on credit enhancement to form a view of the credit quality of specific tranches and 2) the knowledge that this information is disclosed could be a reference point to assist setting appropriate capital requirements frameworks. With regard to 2). e.g., the proposed Basel framework includes a risk weight cap available for originators which references the capital held against the underlying pool. Disclosure would enable investors to use this information to benefit from the same provision. [7] Some banks and building societies already do something similar to this where they disclose the risk weights for their mortgage books as part of their Pillar 3 disclosure.

Alternatively or in parallel, we think that the establishment of an industry wide independent ECAI is possible, which is both transparent and accountable and which benefits from a coalition of views and expertise from all sectors of the industry along the lines of ISDA or the Dutch Securitisation Association. We envisage that the benefits of such an entity could be to ensure greater consistency and reliability of rating criteria so that its methodology represented commonly agreed principles. The volatility created by the unilateral introduction and retraction of criteria (as experienced with S&P in 2010-2)[8] could potentially be avoided through the involvement of a coalition of market participants that would ensure methodology changes were kept appropriate, risk sensitive and only carried out after a full review of the potential impacts on the full range of stakeholders and the wider economy.

6) Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?

If the 'qualifying certification' was tied to appropriate regulatory treatment, we think it could facilitate the return of a well-functioning market.

There are a number of different definitions/criteria in the market relating to eligible securitisations, for example securitisation eligibility criteria differs between the Eurosystem Standard Collateral Framework and that of the Bank of England. Furthermore a different definition is used for an EIOPA Type A Class of securitisation. To facilitate greater clarity and understanding by investors, we suggest, one definition such as a "qualifying securitisation" is adopted throughout the market and in regulations. Otherwise, we think

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[7] See Basel Committee On Banking Supervision Consultative Document 269 "Revisions To The Securitisation Framework" published December 2013,p 19.
[8] See our response to the ESMA discussion paper p 6, referred to in note 4 above. See also Duponcheele, Perraudin and Totouom-Tangho (2014) "Reducing the Reliance of Securitisation Capital on Agency Ratings" for reliance on ratings.

having different definitions emanating from various regulations, regulatory bodies and industry bodies may undermine the aims of developing a “qualifying securitisation” definition.

7) These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a ‘qualifying securitisation’? What are the associated risks?

We believe the framework should be developed in conjunction with existing industry bodies and major securitisation issuers and investors within Europe, so that they can contribute their experience, research and expertise to ensure the framework works in each European Jurisdiction, incorporates both investors and issuer’s views and is delivered quickly and efficiently.

We believe there are three different roles the regulatory authorities could take in the process of certifying that a transaction is a “qualifying securitisation”:

1. Regulating the framework and managing the entire certification process in-house – this could be costly as new systems, process, resource and time will be required.
2. Regulating the framework and setting policy but outsourcing the administrative process around certification – through the tender process the authorities can utilise existing processes, systems and expertise that may already exist in the industry, thus reducing initial costs. There is a risk that the outsourcee does not perform their role to the satisfaction of the authorities but this could be managed through the authorities’ governance and oversight.
3. Regulating the framework and setting policy but the administration of the certification process is managed by an independent private entity. The risk that the private entity does not perform in accordance with the framework and policy could be prevented by the authorities regulating the private entity(ies) responsible for administering the certification process.

We are mindful that creating a “qualifying securitisation” definition and the implementation of supporting systems, processes and documentation will take time, expertise, resources and incur costs. Much work has already been done by the industry to support securitisation. If new initiatives involve excessive costs for the industry, this would increase the cost of the securitisation making securitisation less attractive than other forms of funding. We recommend that any task force tasked with developing the framework for QS works in close partnership with the industry to avoid duplication of work and ensure the quickest and most efficient delivery of any initiatives around QS. In this respect, we think that option 3 above is potentially the most cost-effective and scalable solution for a certifying body. In this respect, if it were willing to adapt its remit, the independent organisation PCS is in many ways a ready-made entity that could take forward this work with relatively little addition work and expense. We note that similar precedents exist in the market – e.g. the STEP initiative which provides labels for commercial paper programmes is an example where the certification activity is performed by an independent, not-for-profit organisation as is the Covered Bond Label.[9]

8) Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?

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[9] See http://www.stepmarket.org.

Loan level data. In the UK and in Europe, following the introduction of loan level data templates needed for repo eligibility, loan level data is already available in accessible form.

We support the BoE's approach to loan level data access: in Europe the European Data Warehouse charges a fee to issuers in order to host their data and investors to view it, whereas the BoE does not require the data to be hosted on a specific fee-charging website, saving costs for both the issuer and investor. We support a similar approach being extended to all QS - our experience is that while investors do not use this data often, they take comfort that it is available to be used if needed and it can be used by third party modellers on whom investors rely.

We take this opportunity to repeat Yves Mersch's point that the significant progress made in the creation of harmonised disclosure standards via the ECB and BOE in the securitisation market has not been matched by asset classes which have far lower capital requirements than those proposed for securitisation. Regulatory capital proposals have not kept pace with either legislative progress on securitisation e.g. risk retention or market initiatives on transparency standards which are best in class for asset-backed fixed income investments.

9) Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?

We mention at Q5 above various suggestions regarding disclosure of credit related features as well as suggest where the relevant task force could explore the ways in which the securitisation industry could make better use of data available from existing sources outside securitisation at Q9 below.

We believe the activities currently undertaken by authorities around standardisation of prospectuses and investor reports is sufficient. We do not think there is any value in re-collating all existing disclosure in a second, unified location. For UK RMBS most disclosures are now currently available via the originator's website which is the natural most intuitive place to search for updated information. It is unlikely that having a second portal would provide any additional benefit to investors.[10] However we would like to see the level of disclosure seen in the UK replicated in other jurisdictions across Europe.

Regarding trade transparency, as investor we would like to see publication of aggregate trade data showing the volume and traded price for transactions in ABS e.g. by a body similar to Markit.

In addition, we think that CRAs should be required to make all rating methodology and all publications relating to a securitisation throughout its lifecycle (from pre-sale report to rating downgrades and upgrades) freely available to the public, without paywall or password protection. Currently some or all of this information (such as new issue reports). is only available to people who have paid a subscription This presents an obstacle to interested observers such as independent academics, research analysts etc. who can play a valuable role in studying the securitisation market and reviewing the rating history of certain transactions as well as investors and other market participants with an interest in market wide developments. It also reduces the accountability and transparency of the CRAs, particularly with regard to their appraisal of legacy transactions. At the least, free access should be made available to users that are not necessarily issuing or investing institutions.

[10] However, we do think that data disclosed by originators should be available to all, without password protection.

10) Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?

Nationwide does not currently originate SME or commercial real estate ('CRE') securitisations. However, in principle our view is that facilitating investors' access to credit data on the assets securitised in these types of securitisation could facilitate development of the market. We do not believe that this question is relevant to UK RMBS as the existing loan level data already includes anonymised borrower credit scores.

11) In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

We are not aware of macro-economic data that should be disclosed to facilitate securitisation. We do think that it would be helpful for the market if issuers of RMBS across Europe moved toward a standard definition of an account being in arrears (to the extent possible and operationally feasible) as currently there is some variance.

We think that industry bodies in different jurisdictions either have or are in a position to collate data which could facilitate securitisation. We recommend that any European QS task-force engage in a dialogue with the relevant bodies in each jurisdiction to explore how these existing bodies and the data to which they have access could be better used to facilitate securitisation, e.g. through collation or publication of country level performance statistics on the different asset classes used. For example, in the UK, the CML currently publishes UK level arrears data and might be able to assist with publication of UK mortgage loss performance data.

Per our comment at Q 5 above, we also think that it could be beneficial if the capital held against the underlying pool assets was disclosed and there were some standardisation of this across Europe, e.g. through including the information in the prospectus or final terms. Similarly, it would be beneficial if non-bank originators also disclose equivalent information, e.g. expected losses for non-bank portfolios.

We think that the challenges to providing standardised loan level data to investors have been largely overcome by the efforts of the industry and through central bank initiatives – we have seen a great leap forward in this respect post-crisis. We would welcome any initiatives which encourage a convergence of disclosure standards across different asset classes and jurisdictions throughout Europe.

12) Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

In principle, we welcome initiatives such as benchmark indices which could encourage securitisation through disclosure of performance benchmarks and think this might be facilitated through leveraging existing industry bodies that collect such (or similar) data at a country level as described in Q11. We do not fully understand the second element to the benchmark indices described in para. 116 of the Paper and await further details before commenting.[11]

13) Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

Yes we have advocated the disclosure of such an implied rating in the past. This would be simple to achieve through the introduction of an additional sentence in the initial ratings letter which in addition to the customary ratings, would confirm that the rating "assuming the rating of the sovereign and the ancillary facilities providers (swap counterparties, account banks (list others) was the minimum consistent with a [AAA] rating, the rating of each tranche would be as follows: [●]".

14) How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

The authors have identified an important area where improvements could be made. On the one hand, account bank exposures have increased following the crisis due to increased CRA VBs. On the other more stringent liquidity rules mean that firms have to anticipate outflows assuming ratings downgrades, which means that banks have to hold increased cash and/or liquid assets to reflect the VBs, increasing the liquidity costs associated with the securitisation. At the same time, central bank facilities accepting securitisation collateral will further haircut securitisation bonds where large cash balances have built up with an account bank to reflect the risk of a jump to default by that bank, notwithstanding the fact that at one level the collected cash represents a reduction in risk to the structure as performance risk on the underlying has been removed for the collected balance. Furthermore, additional ratings volatility in times of stress may require originator account banks to export large balances to one or more banks which in turn may need to be transferred again if one of those is downgraded. In addition, large balances may need to be divided among more than one bank and if a transaction has an standby account bank in the structure, even where that standby account bank has not been activated, the SPV may need to engage in costly and potentially unnecessary amendments to re-assign that role to a substitute if it breaches the rating threshold even though that substitute may either never be used or itself be downgraded and replaced. Thus the area of residual account bank risk has become problematic due to developments since 2008.

In addition to the collateral issues, a second problem area in relation to swaps is where the crisis and ensuing swap downgrades has led to multiple downgrades of securitisations which has necessitated costly restructurings of securitisations as well as depleted the universe of eligible swap counterparties as acknowledged in the Paper. Such depletion increases the costs of swaps to transactions and we agree concentrates risk in a smaller number of swap counterparties. In addition, as mentioned post-credit crisis CRAs have introduced onerous cash collateral requirements which increase the exposures of SPVs to account banks. Facilitating SPV bank accounts that fall outside the originator's insolvency estate could assist with both of these problems.

We think that it should be possible to facilitate ring-fenced SPV accounts that are bankruptcy remote in an efficient manner such that the resulting benefits outweigh the

[11] The DP refers to "performance data can be used to develop improved risk transfer products, including by separating asset types into "index" risk and institution- and security-specific "basis" risk, which are important for investors to help align their exposures with their risk appetite. A handful of tradable indices may, however, encourage imperfect hedging or damage confidence if sold heavily during a period of market turmoil".

costs. This problem has been resolved in some jurisdictions such as the US through the trust account mechanism. We believe that something similar could be achieved in Europe e.g. account banks that hold funds in an account in the SPVs name might be able to deposit funds in a reserve account with the central bank which is ring-fenced in favour of the SPV, thus removing the credit risk on the SPV's cash account with the account bank. Without some element of access to central bank facilities, we understand that implementing a trust account mechanism similar to that found in the US is difficult to achieve in e.g. the UK for legal reasons.

We think that addressing the above problems could reduce counterparty risk and provide a very worthwhile improvement to European securitisation products. We recommend that the Bank of England and the ECB work together with the industry to explore these solutions, though as a second priority to resolving the market critical issue of implementing appropriate capital charges.

15) With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?

No.

16) Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

Please see above.

17) Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?

The securitisation market has taken decades to develop and mature. At present there are €1.43tn securities outstanding in Europe[12]. We do not see a viable alternative financing mechanism that would achieve the full-range of benefits of securitisation, since to achieve such benefits a financing structure would inevitably have securitisation-like features. There are a variety of options that can provide the same or similar benefits to securitisation on an ad hoc or idiosyncratic basis (e.g. asset sales to insurance companies), but in terms of creating a global liquid and deep market where risk can be bundled up into smaller packages and distributed to those most willing and able to hold it, (including those outside of the banking sector) we can not conceive of an alternative to securitisation but only some variation of it.

18) Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?

Subject to the suggestions made in question 5, the principles seem broadly sensible taking into account the objective of encouraging a set of securitisations that are more amenable to risk assessments.

[12] Source: AFME data report, Q1 2014.

We are encouraged by the authors' commitment to reviving a well-functioning securitisation market and would be happy to assist you any further regarding the matters discussed in the Paper.

Yours faithfully

Andy Townsend

Treasurer

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European ABS Strategy

Special Topic

The BoE & ECB's Case for Securitisation

Five key takeaways from what may be an important step in the road to recovery.

As of

2 June 2014

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On Friday, the much-awaited Discussion Paper "The case for a better functioning securitisation market in the European Union," was jointly published by the ECB and Bank of England. The authors discuss the potential benefits of securitisation, outline many of the impediments facing the market, and present several actions policymakers could potentially take to improve the market's health. For those in the industry, it is not terribly enlightening. It offers little in terms of a roadmap or timeline to overcome the challenges facing the market, and it is light on details in some key spots. But viewed as a basis for discussion among policymakers, it is comprehensive and pragmatic, and as such it may represent an important step in a long process of reviving European securitisation. Moreover, reading between the lines we find several interesting (and encouraging, in our view) points in the paper. Rather than summarizing the document here, we discuss these in five key takeaways below, focusing on policy options and the direction the central banks seem to be taking with respect to EABS revitalization.

The BoE and ECB did their homework. Though not perfect, we believe the paper has an impressively comprehensive summary of the challenges facing the EABS market, as well as the benefits securitisation could provide in Europe. Impediments such as Basel III and Solvency II were noted, but so were other factors less obvious to those outside the market, such as the dwindling number of swap counterparties which meet strict rating agency criteria. It noted both the risk that regulatory over-conservatism may limit market-makers' ability to provide liquidity to investors, and the distorting effects of the market's perception that implicit guarantees exist on other forms of debt (e.g., covereds). This level of detail points to a solid understanding of securitisation which had been lacking in some regulatory circles in recent years.

Support for more robust intervention is growing. The ECB has grown more vocal in its support for securitisation, while the BoE has until this year (and particularly under Governor King) seemed far less supportive. Now the BoE has joined the ECB to make a strong case for more robust government/regulatory support of the European securitisation market. They state, *"There are clear reasons to suggest it may be desirable for authorities to intervene in securitisation markets… In the absence of intervention, it is uncertain whether [the benefits of securitisation] will be fully realized."* The potential actions mostly concern standard-setting and ensuring consistent regulatory treatment, which themselves would be big steps forward. However, the BoE and ECB also discuss more involved options, such as protecting ABS issuer bank accounts in the event of an insolvency, and encouraging rating agencies to provide more clarity on how factors other than collateral/structure risks affect their opinions (i.e., counterparty risk, sovereign caps). The most important, however, is the proposed framework for "qualifying securitisations" outlined in the document (see below)

It's not just about SMEs, banks and "low risk" assets. The paper's focus is encouragingly broad, on securitisation in general rather than just on SME-backed ABS. It also notes several macro-economic benefits of non-bank securitisation. More interestingly, the potential "actions" discussed (the authors refrained from using the term "recommendations") indicate that the BoE/ECB do not seek to restrict securitisation to low-risk assets only. The paper notes that while some ABS are very low risk, no ABS is risk-free, and some SME loans suitable for securitisation are higher risk than some consumer loans. Following the publication, BoE Deputy Governor Jon Cunliffe reportedly said in an interview today that there is "nothing wrong with including high-risk assets in securitisation" as long as the risks are transparent.

The comparison with covered bonds is made clear. The paper attacks the notion that all ABS are higher-risk than covered bonds, stating "*that some prudently structured, high-quality ABS tranches may provide credit protection comparable to covered bonds that have similar underlying collateral.*" It recounts the solid performance of EABS and argues for a "uniform approach" to their regulatory treatment in order to reduce regulatory arbitrage and "*incentives for undue overreliance on one type of instrument at the expense of the other.*" To date, Draghi occasionally indicated that low-risk senior EABS risk is similar to covered bond risk, but this paper contains perhaps the most robust and clear argument to date from any European regulator for a level playing field.

The BoE/ECB is taking a pragmatic approach to "High Quality" criteria. Momentum is clearly building for "High Quality" criteria which could allow for more equitable regulatory treatment of ABS. Without it, it may be difficult to convince more skeptical policymakers that the "bad ABS" is a thing of the past. It may also be necessary to allow the bodies who authored current regulatory proposals to retain credibility while changing them. In our view, the "high quality" proposals to date (summarized in Figure 1), including the PCS program, have limited flexibility too much in one way or another.

We believe the BoE/ECB's principles-based approach, though not perfect, provides a reasonable and pragmatic basis for discussion. It suggests that a "qualifying securitisation" should be one for which "risk and pay-offs can be consistently and predictably understood." Collateral should be non-delinquent (at issuance), homogeneous and, if secured, first-lien. Enough history on similar loans should be available to allow for assessment of cashflow risks (the BoE separately suggests that national credit registers may help in this regard[1]). These criteria are not wholly unreasonable or surprising. In our view, however, the proposal is more encouraging for what is not included in the criteria than what is. Specifically, it:

- **Does not seek to apply one set of criteria to all purposes**, so what qualifies as "liquid" may be different than what qualifies for lower capital requirements.
- **Does not explicitly preclude specific asset classes**. While some sectors would not likely qualify due to specific loan features, the proposal would allow a wider range of asset classes than EIOPA's approach, and what is currently PCS eligible. Commercial real estate mortgages could potentially qualify, for example.
- **Does not include rating, maturity or structural requirements** (i.e., waterfall types and number of tranches), unlike the EIOPA and Australian PRA proposals. Rather, it seeks to ensure transparency of risks, structure and collateral are met. While it does not require minimum ratings, it suggests ratings from two agencies be required on an ongoing basis.

It is important, in our view, that any set of "High Quality" criteria allows issuers and investors some flexibility inherent in ABS with respect to collateral types and structures. While further purpose-specific criteria would surely be used in this framework, we feel the BoE/ECB approach has a key advantage over others in this regard.

That said, some of the principles are not yet clear to us, making it difficult to opine on them without further details. These include the requirements on "recourse" (is it full legal recourse to borrowers?), "perfection of interest" (how would it apply to UK RMBS deals where legal title is not usually transferred at issuance?), and "self-liquidating loans" (does that mean all loans must be fully amortising?). We hope the central banks would take a pragmatic approach to these criteria as they have to most other requirements, but as is usually the case with these things, the devil is in the details.

Conclusions

More importantly, we hope that the BoE and ECB's efforts will help give other regulators a better understanding of European ABS and the distortion effects that current proposals have on the fixed income market in Europe. Their discussion paper may be short on details and specific recommendations, but as a comprehensive foundation for policy discussion, it may ultimately prove to be an important step in reviving the securitisation market in Europe.

[1] Another BoE Discussion Paper published last week discusses the potential benefits of making UK credit data more widely available. Click here for details.

Figure 1. Comparison of "High Quality" criteria in various proposals & PCS

Framework Component	EIOPA	Australian PRA	PCS	BoE / ECB
Rating	✓	×	✓	×
Seniority	✓	×	✓	×
Transparency (LL data)	✓	✓	×**	✓
Risk Retention	✓	✓	✓	✓†
Purpose of Securitisation	×	✓	×	×
Collateral types	✓	×	✓	×
Homogeneity of collateral	✓	×	✓	✓
Meet Lending Standards	✓	×	✓	✓
Full doc / income verification	✓	×	✓	×
No credit-impaired loans	✓	×	✓	✓†
LTV limits (resi)	×	×	✓	×
True Sale / Separation	✓	✓	✓	✓
Servicing continuity	✓	×	×	✓
Tranche Limits	×	✓*	×	×
Waterfall	×	✓	×	×
Call restrictions	×	✓	×	×
Minimum Size	×	×	✓	×

*Source: APRA, EIOPA, BoE, PCS, Nomura. *APRA proposes to allow multiple "B" class notes in capital relief securitisations, but limits funding-only deals to 2 classes (see "Simplifying the Prudential Approach to Securitisation, 29 Apr 2014). **PCS requires loan-level data at issuance only for non-granular assets; for granular assets, only "detailed summary statistics" are required. †The BoE/ECB proposal implies prudent underwriting is required; risk retention was excluded from the criteria because it is adequately covered in other legislation.*

Bank of England/European Central Bank Discussion Paper

The case for a better functioning securitisation market in the European Union

A response from the Paragon Group of Companies

July 2014

Introduction

About Paragon

The Paragon Group of Companies PLC is a FTSE 250 business, comprising several specialist companies. Paragon has three core business lines as a mortgage lender, debt purchaser and servicer and bank.

We have extensive experience in the securitisation markets, having been the first UK company to securitise loan assets in 1987 and since then we have completed 57 transactions. Our use of securitisation enables us to match-fund our balance sheet, ensuring that finance is in place for the life of the underlying mortgages. All our securitisations have been simple, straightforward and transparent.

Through our buy-to-let mortgage business, Paragon Mortgages is the UK's leading specialist provider of residential investment mortgages to landlords. We launched our first, specifically targeted mortgages in 1995 and over the last 18 years have increasingly specialised in this market. With over 40,000 landlord customers, more than 91,000 customer accounts and £8.7 billion of assets under management, we remain a leader in our market.

In February 2014 we launched Paragon Bank offering straightforward, competitive savings and loans for consumers and SMEs. The launch of the bank enables Paragon to diversify its funding through raising retail deposits and utilising its extensive experience in consumer finance by delivering a range of lending products to UK consumers.

Prior to the launch of our banking subsidiary, Paragon was a non-deposit taking institution that depended entirely on the wholesale funding markets in order to originate new loans. We still utilise the wholesale markets for the majority of our funding requirements. In March 2014, we issued our fourth securitisation since the financial crisis, and we are presently marketing our fifth such securitisation, which is planned to close in July 2014.

Response to discussion paper questions

Q. Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?

We would agree that a well-functioning and robust securitisation market is essential as part of a well-balanced financial system supporting the real economy.

Using high quality assets with a proven track record and in straightforward structures, securitisation allows banks and non-banks to make more efficient use of their balance sheets, increases funding diversification, promotes competition and diversifies risk within the financial system.

Disruptions to the securitisation markets can result in a significant decrease in the flow of finance to the real economy, mortgage availability in particular.

The growth in lending by non-deposit taking lenders in the UK prior to the credit crisis played a key role in driving innovation in the wider domestic mortgage market. Council of Mortgage Lenders' statistics show that in 2007, six of the top 30 lenders were non-deposit taking lenders. However, after the onset of the financial crisis, non-deposit taking lenders were largely unable to access the wholesale funding markets, leading to a downturn in lending capacity, competition and innovation.

Paragon's experience during the financial crisis is a case in point. Paragon Group navigated the crisis well and without recourse to any state support or taxpayer-funded finance scheme, but the closure of the wholesale markets significantly affected our lending capacity. Before the financial crisis, Paragon financed one-in-ten of all residential property investment mortgages in the UK, helping to maintain a private rented sector that plays an increasingly important role in the UK's housing market. Paragon withdrew from lending in 2007 when it became clear that wholesale funding conditions were becoming extremely difficult.

While government support was directed at the too-big-to-fail banks, with complex and highly leveraged balance sheets, Paragon, as a non-bank, stood ready to lend to the real economy although had to wait until September 2010 for wholesale market conditions to improve sufficiently for it to resume lending.

Q. Do respondents agree with the impediments to, and economic concerns of, investors that have been identified? Do respondents think there are any additional impediments to investors, and if, what are they?

In our view, securitisation markets have improved markedly since Paragon resumed lending in late 2010. We launched our most recent securitisation only six months after our previous issue but at a much more favourable price with highest rated notes 30 basis points cheaper.

However, we agree that there are a number of potential weaknesses that need to be considered. The discussion paper has correctly identified the regulatory treatment of securitisations as an impediment. We see symptoms of the wider tension in the dichotomous public policy goals of fixing the last crisis and encouraging the flow of finance to the real economy, but there are several specific dimensions for securitisation markets, as detailed below:

- Capital and liquidity are the main impediments for the desire of certain investors to hold RMBS. Credit quality is not an issue when it comes to straightforward RMBS issues backed by high quality assets.

- The BCBS/Solvency II proposed capital weighting are entirely disproportionate to the level of loss experienced on EU securitisations during a period of severe stress and act as a major disincentive to engage in the market.

- The discrimination against securitisations in terms of liquidity is set out convincingly in Perraudin's paper, 'High Quality Securitisation' and acts as a further disincentive for the market to develop. In particular, the acceptance of RMBS as HQLAs would have a direct impact on the breadth and depth of the investor base. Currently, the real and perceived institutional bias against securitisation results in it being marginalised as an asset class. Limited resources are employed to the securitisation market as its scope for growth appears constrained in the medium to long-term and consequently the charge of limited liquidity becomes self-fulfilling.

Q. Do respondents agree with the impediments to, and economic concerns of, issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think there are additional impediments to issuers and if so what are they?

Whilst we can understand that other issuers might experience some of the problems identified in the discussion paper, Paragon has a track record of success in the securitisation market based on a consistent approach and a strong, long-established reputation among investors. We are an exemplar of well-performing transactions and all of our 57 securitisations have been straightforward, transparent and low-risk.

Paragon does not sell any of our loans onto third parties but retains all originated assets on our balance sheet in securitisation vehicles. These are supported through investment in the First Loss Tranches (FLTs) of the securitisations, which is essentially equivalent to the capital held by banks. These FLTs, which expose Paragon to the highest economic risk of the securitised assets, are retained for the duration of the securitisation's lifetime. This ensures that our interests are already fully aligned with those of our bond investors. We do not believe that a radical relaxation of the retention requirements is particularly necessary.

We also note the paper says that withdrawal of official sector schemes such as Funding for Lending may reduce the expense of securitisation.

However, in the current climate the strong investor demand for yield has allowed us to reduce the price of our securitisations precisely because FLS had reduced banks' need to go to market for wholesale funding. Therefore, the prediction in the paper may turn out to be incorrect with the result that prices actually increase for many non-bank lender securitisations as the schemes continue to be withdrawn.

Paragon agrees there should be an alignment of interest between investors and sponsors of securitisations. Paragon has never operated an 'originate to distribute' model and has always retained a significant first loss position in its pre and post-crisis transactions.

However, the current EBA fixed retention rules are one size fits all solution with no calibration versus the risk of the underlying assets. Retaining a 5% first loss on UK RMBS can result in the resultant capital structure achieving a double-A rating as the level of capital is multiples of the expected loss. The lack of risk transfer and capital inefficiency makes the current level of retention highly unattractive.

The EBA rules compound this inefficiency by refusing to allow the economic interest to be split between different types of retainer. Rating agencies typically require a 3% non-amortising, cash first loss retainer on UK RMBS to support a triple-A rating. The additional 2% is then provided in the same form of first loss when a more efficient route would be, for example, a 2% vertical slice. We fail to see the logic of not allowing this form of retention as it is clearly more 'at risk' than a simple 5% vertical slice.

The retention regime favours banks versus non-banks, as first loss retentions for banks are held at the capital weighting appropriate to the underlying mortgage assets. This misalignment between banks and non-banks ultimately impairs competitiveness. In addition, it has the potential to reduce the attractiveness of lower risk lending for non-banks, which conflicts with the objective of the retention regime itself. An approach which seeks to align retention levels with capital requirements (in a simplified manner) would help to remove this distortion.

Q. Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

We agree lack of market liquidity may be a barrier to a well-functioning securitisation market.

The securitisation market is currently dominated by buy and hold sellers who are likely to place less emphasis on liquidity. However, in order to broaden the investor base, liquidity could, and should, be improved. Credit risk is not an issue, whereas lack of liquidity is. Simple RMBS structures should enjoy similar

HQLA treatment as covered bonds given that their historical trading performance is comparable – see Perraudin.

Q. The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

We agree with the definition.

Comments in relation to the principles in Box 3 are as below:

132 Current and self-liquidating - There should be a limited allowance for delinquent accounts (less than 1%) in order that the pool is representative of the general performance of the asset type and not cherry picked. This is also important for institutions that wish to refinance assets by calling old deals and including such seasoned assets in a new securitisation.

133 Security - Whilst this has to be valid and enforceable, and against an asset which is fit for purpose, security should not be restricted to first lien. Second lien lending is an established product with an established record of performance over numerous economic cycles and which, if targeted to prime quality borrowers, should be included.

135 Perfection of interest - We agree with the definition in 135 and all our Paragon securitisations comply with it. In our experience, the EBA has insisted that the Issuer is also an 'orphan' SPV in order to be ECB repo eligible. This addition appears to be a 'tick box' exercise, adds cost and complication and is unnecessary if the structure meets all of the conditions in 135.

Q. Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?

In line with earlier comments:

• Previously securitised loan assets should not be excluded from new securitisations. Doing so would create funding issues for non-banks.

• Buy-to-let borrowers typically rely on the proceeds of sale for repayment, and this in itself should not be regarded as a problem, since the asset is an investment rather than the borrower's residence.

• There is no reason why high quality second lien assets should be excluded from qualifying securitisations.

Q. Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualification certification'?

We would agree a 'qualifying' securitisation certification, in conjunction with other central bank measures, such as inclusion in LTROs, would help to support increased liquidity and create a more liquid market for securitisations.

We would support the concept of 'qualifying' securitisations. We believe this should encompass all the major asset classes; mortgages (both residential and buy-to-let), auto, credit cards, unsecured retail loans and second lien loans.

Q. These principles may then provide a framework to aid various authorities and market participants to set their eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a qualifying securitisation? What are the associated risks?

The process developed for inclusion of RMBS as qualifying assets under the DWF worked well, and this model could be used as both the starting point and basis to develop the eligibility criteria for 'qualifying' securitisations.

The process would be improved if the confirmation of the 'qualification' could be achieved prior to issue of new securitisations, rather than post issue as is the case presently for Bank of England SMF eligibility and ECB repo eligibility.

The eligibility criteria would best be developed with input from the securitisation industry. Ongoing certification would be more efficient if it was outsourced to a separate non-profit organisation.

Q. Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level be improved, so that it provides most value to investors?

We agree conversion software may be useful. However producing the templates themselves is not an onerous task. The usefulness of such templates could potentially be improved if there was a single template covering both the Bank of England and the ECB.

Access to templates could be improved by requiring issuers themselves to make the template widely and freely available, rather than solely through a central portal.

Q. Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?

We think that initiatives for standardisation of prospectuses and investor reporting which have been implemented to date are sufficient for the market as a whole.

Whilst prospectus harmonisation is a laudable goal, it is important to understand that because of the complexity of securitisation a 'one size fits all' approach may not always be the best. Ultimately, the Issuer is responsible for ensuring adequate disclosure in the prospectus and this may best be achieved without reference to a standardised template.

What is most important is that all relevant information can be easily found. Therefore, annotated prospectuses and the introduction of portals to enhance access to data and documents would help.

Q. Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?

In the UK, there is already a significant level of mortgage loan by loan information and ongoing performance data now available to investors. The utilisation of this data could be improved if tools for analysing the data were more generally available at an economic cost.

The provision of credit information can be problematic, since issuers are not the owners of the data, and linking live credit data to assets would most likely conflict with confidentiality and Data Protection Act requirements. Therefore, we would not see this as an immediate priority for the RMBS sector.

Other sectors where there is less publicly available information would benefit from credit registers.

Q. In order to aid performance measurement and to provide investors with industry-level data, would it be helpful is certain macro-economic data were disclosed or if banks/non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improved secondary market functioning for high-quality securitisation?

We do not believe that specific requirements for additional macro-economic data or aggregated lender data would be directly beneficial to mortgage securitisation markets.

Participants already provide a significant amount of information on their loan books. It may be helpful for investors when comparing lenders to ensure banks publish similar data where they do not already do so.

Q. Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

NA

Q. Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

Although not directly applicable to Paragon, we understand how such a matrix would help investors assess the degree of granular credit risk inherent in the underlying transaction and the potential rating upside if the sovereign's credit rating improves.

Q. How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this areas that would be beneficial?

It is very important to have as few impediments as possible in relation to ancillary facilities (the providers of which are often referred to as support counterparties) for SPVs as it is very difficult for the securitisation market to develop without such counterparties.

We would agree the benefits of facilitating SPV accounts that fall outside the originator's insolvency estate would outweigh the costs of such initiatives.

In considering connectedness of SPVs, the exposures within SPV exposures to support counterparties should be viewed separately from the underlying securitised assets. Support counterparties, such as account banks and derivatives counterparties, are put in place to support the SPV are principally bondholder risks and will disappear when the SPV collapses and the assets revert to the originator. Therefore, whereas a presumption of connectedness for the underlying securitised exposures is arguable, there should be no such presumption of connectedness for support counterparties.

The range of SPV bank account and swap providers is fairly small, and an automatic presumption of connectedness to non-recourse SPVs, absent an ability to demonstrate otherwise could undermine the re-establishment of a wider securitisation market. Therefore, the clarification of appropriate, large exposure treatment, to specifically exclude support counterparties, by regulators in respect of SPVs would be beneficial.

Q. With regard to the policy options mentioned above are there any other considerations authorities should be mindful of?

NA

Q. Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

NA

Q. Beyond securitisation, might there be other ways of achieving some of the benefits of securitisation as outlined in section 2? What might be the associated risks of such options?

We believe there is an urgent need for the Bank of England and the ECB to promote securitisation and welcome this initiative.

We take this opportunity to reiterate that, in general, the securitisation model has ultimately been successful and investors have suffered negligible losses apart from on certain CMBS transactions. Whilst shortcomings in – synthetic securitisations, rating agency analysis and due diligence contributed to the financial crisis and have rightly been the targets for regulatory action, a reformed securitisation market will bring major benefits to the real economy. Promoting alternatives runs the risk of causing confusion and even disillusionment amongst participants. The continued solitary confinement of the securitisation market will have the inevitable consequence of reduced lending and ultimately reduced economic activity.

The Paragon Group
July 2014

A response to the Bank of England and ECB discussion paper

4th July 2014

CONTENTS

Prime Collateralised Securities ("PCS") would like to thank the Bank of England and the European Central Bank for the opportunity to respond to the many issues raised in the discussion paper entitled "The case for a better functioning securitisation market in the European Union" published in May of this year (the "Paper"). Also we would like to express our view that this paper is excellent and sets out one of the best and most comprehensive approaches to the issues raised by securitisation generally and in the context of European finance and the funding of the economy specifically. It is difficult to think of a question relevant to these issues that is not effectively broached in the Paper.

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 is 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

[A] PCS strongly agrees with the need to define 'qualifying securitisations' and with the approach of doing this on a conceptual basis and including, potentially, all the tranches of a transaction.

[B] PCS also strongly supports the work done by European Commission and European regulatory authorities in defining high quality securitisation and bifurcating the regulatory outcomes based on this definition.

[C] PCS broadly agrees with the approach and the rules set out in Box 3 as a possible definition of 'qualifying securitisation'.

[D] PCS believes that a single definition of 'qualifying securitisation' should be set in all legislative and regulatory texts and should be used in each regulation that touches upon securitisation. This will also allow appropriate additions to meet the specific aims of different regulatory schemes.

[E] PCS believes that the certification of 'qualifying securitisations' will be necessary. We further believe such certification is best done by one or more independent, not for profit private sector entities under strong public authority control.

[F] The use of the definition of 'qualifying securitisation' should allow high quality securitisations to be fairly treated in regulation and receive treatment commensurate with their actual risk and with other high quality investment tools.

[G] Although PCS believes that a definition of 'qualifying securitisation' should be ultimately of global application, it strongly urges European policy makers to move ahead swiftly rather than wait for a global consensus. PCS also believes such a global consensus should be sought and would be beneficial.

RESPONSE

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

Question 1. Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?

Section 2 of the Paper is extremely comprehensive and we find nothing meaningful to add or with which to disagree.

We would merely highlight some of the positive consequences of items that are mentioned in Section 2.

Securitisation as a conduit to correct global and European imbalances in savings

First, in paragraph 38, there is a reference to geographical diversification by investors. We believe this is a very important aspect of securitisation both globally and within the European Union. It is a trivial statement that trade and developmental patterns at a global level, as well as cultural and other societal conditions, have led to savings pooling geographically in a very uneven way. It is also widely recognised that there is a "glut" of savings at a global level and yet, this recession is also characterised by difficulties for smaller businesses in Europe to access finance.

Over the medium run, a strong and liquid securitisation market of high credit quality has the potential to attract savings from outside of Europe to finance parts of the economy that do not have a natural access to global capital markets. Within Europe, such a market has the potential also to move savings from where they are pooled to where they may be best utilised. This, in turn, has the potential to help the European Union to move towards a more integrated financial market and replicate the benefits to the economy that such integration has demonstrated in the United States.

Securitisation as a tool to improve banks' exposures distribution

Secondly, we would add another benefit to banks and their systemic resilience – which, to some extent, is a corollary of the benefits of proper risk transfer and the attendant capital relief. This is the ability of banks to create a more balanced spread of risk. In other words, by transferring some types of risk through securitisations (e.g. local housing finance) and, potentially, buying, again through securitisation, different types of risk (e.g. aircraft finance risk) the bank can manage the diversification of its exposures while maintaining the benefits in credit origination deriving from client knowledge. Irrespective of its capital position, such a diversification must be a factor of resilience by lowering the exposure of a bank to unforeseen catastrophic credit problems in a given asset class or area.

Pro-cyclicality (paragraph 44)

Assuming proper “skin in the game” requirements, PCS is not entirely convinced that securitisation would play a strong role in reducing the dependency of banks’ lending decisions on the business cycle (paragraph 44). Since the bank would still need to be exposed to the potential losses of a given sector even post securitisation, the pro-cyclicality of lending decisions would not likely be eliminated. However, what is correct is the earlier statement in paragraph 44, namely that securitisation can play an important role in reducing the dependency of banks’ lending decisions on the conditions of banks generally. This can indeed be a strong current pushing against pro-cyclicality. Without eliminating it, it would still reduce the dependency on the cycle.

Question 2. Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?

The section on investor concerns reflects statements that we have heard from the investor community. We hope that a sufficient number of investors will also respond to the Paper thus providing a sharper view of their position.

Market size

We believe a major problem for investors – existing and potential – and a very serious risk to the entire European securitisation market, is the extremely low level of issuance.

This low level has a number of causes, addressed in the Paper. However, the low level of issuance means that existing investors are struggling to redeploy redemptions. These are now running at a meaningfully higher level than new issuance. New investors are not interested in working out whether and how they might want to return to a market where, even should they decide to return, they will be able to buy only the smallest of volumes. Asset managers are not actively drumming up new funds for securitisations when they know they could not place them.

The risk here is not a market risk, as normally defined, but an infrastructural risk. A certain minimum volume of holdings is necessary, whether for real money accounts or for asset managers, before they can meet their overheads.

Analysts, screens, rent needs to be paid to maintain an asset-backed team. Similar considerations apply to arrangers and even originators.

PCS, based on discussion with market participants, is concerned that the low volumes existing today and the lack of a strong belief that larger volumes are around the corner, are leading many existing investors to consider withdrawing from the market altogether. It is also preventing any meaningful discussion with potential new investors who see nothing to invest in. Should the industry fall into this spiral, the entire European securitisation market could collapse. Of course, a small, bespoke, primarily reverse inquiry market would continue. But the loss of human capital would take a number of years to reverse. This would mean, should this come to pass, that the capacity of the securitisation market to assist the funding of a recovering European economy will be postponed for years.

This is the main reason why PCS believes that the policy making community has a fairly short window of opportunity to create a prudent but workable regulatory framework for securitisation. It is also important that whilst this work is being done, policy makers signal clearly their intentions regarding not only such improved regulatory environment for high quality securitisations but also a reasonable timeframe in which this work is expected to be completed.

In addition, the availability to banks of extremely cheap central bank funding is making securitisation, on a comparative basis, a very expensive proposition. PCS is aware that projected securitisation transactions were cancelled immediately following the announcement of the TLTRO. Although PCS entirely understands the rationale behind such accommodative monetary policy, the policy also has the consequence of retarding significantly the arrival of conditions that would make a renewal of the European securitisation market an economically rational proposition. In view of the precarious state of the remaining securitisation market, PCS would urge the Bank of England and the European Central Bank to examine ways in which they could create the conditions for a renewal of the market consistent with their overall monetary responsibilities.

Securitisation and complexity (paragraph 78)

We also have a comment regarding the supposed complexity of securitisations. We fully agree with the two excellent points made in paragraph 78: first, the requirement to be able to understand one's investment is of universal application; secondly, hurdles to understanding securitisations "may be perceived as higher".

We have argued in the past that when you compare (a) a senior tranche of a very granular residential mortgage backed security originated by a reputable bank with "skin in the game" and benefiting from credit enhancement that is many multiples of historical losses suffered in a bad economic recession against (b) a corporate bond for a large multinational business such as an airline company operating in dozens of countries, subject to issues of liability for accidents, the price of petroleum, regulatory and political risk, a complex competitive environment from corporations not always subject to normal balance sheet and profit constraints (eg flag carriers), it is not entirely evident that the former is a more complex investment product than the latter. Yet, the latter can be sold to retail investors with little, if any, impediments.

PCS also acknowledges that the perception of securitisation as an especially complex product has not arisen out of nowhere. This perception has arisen, in our view, from the disastrous fate of AAA rated securitisations such as US sub-prime RMBS and CDOs of ABS. In the mind of investors, there is a natural (and entirely legitimate) negative correlation between extremely strong credits and the complexity of the analysis that needs to be brought to bear to understand them. The analysis of how such AAAs failed revealed a deep complexity that had to be mastered if one wished to understand the investment one is asked to make.

This is why we believe that the approach to “qualifying securitisations” should seek, amongst other things, to define securitisations that are fundamentally much simpler to understand. If this is successful and can be communicated to investors, this will be a key to re-establishing a broad investor base for such securitisations. It should enable a return to the proper balance between credit quality and simplicity of analysis. (We do not wish to suggest that the analysis of securitisations – even ‘qualifying securitisations’ – should be simplistic. However, it should not be seen as being fundamentally more onerous than the analysis of most other investments of similar credit risk.) This should help to banish what PCS believes to be the myth that securitisations are inherently and definitionally uniquely complex investments.

Question 3. Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?

We believe that the section covers all the economic and other concerns of issuers seeking to securitise of which we are aware.

We would also make the fairly obvious point that just because something is an impediment to securitisation should not mean that it should be removed from the market place if it performs an important and valuable function. This would be, in our view, the case for retention of risk, which PCS views as an essential element of robust securitisations. This does not mean that the rules around retention should not be examined with a view to improvement, but the fundamental principle should certainly remain within any definition of ‘qualifying securitisation’.

Question 4. Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

Definitions of 'liquidity'

We think that the answer to this question turns on the definition of liquidity. Liquidity may be seen either as (a) the volume of a given item that trades every day or (b) the capacity of an owner of an item to sell it swiftly with no or little loss resulting from either the bid/offer spread or transactional costs.

Using the former definition (volume), securitisation in Europe has never been a 'liquid' instrument. Using the latter definition (capacity to sell), there is considerable evidence that securisation has indeed been a 'liquid' instrument. This is even more so with 'high quality securitisations' defined using the key PCS concepts.[1]

Whether securitisation being liquid only under the latter definition is in impediment to new investors coming into this market is an issue that deserves investigation.

At the same time, there can be little doubt that should securitisation become liquid in the former sense, this could only help new investors into this asset class. We are just not sure though that it is a necessary condition for a strong securitisation market to emerge.

PCS does not have an answer to this question at present and would prefer to rely on some data rather than speculate.

Securitisation as a 'buy-and-hold' product (paragraph 94)

We broadly agree. We would also add two additional reasons why we think little European ABS has been traded historically.

First, until 2007/2008, this floating rate product had very stable ratings.

Secondly, demand was almost invariably higher, year on year, than new issuance.

The stable ratings and floating rate aspects of the senior tranches of securitisations made their price extremely stable. The fact that demand outstripped supply meant that investors were buyers not sellers.

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[1] See "High Quality Securitisation: an empirical study of the PCS definition" William Perraudin and Risk Control Ltd, 20th May 2014 (http://pcsmarket.org/wp-content/uploads/2014/06/empirical-study-of-high-quality-securitisation.pdf)

Very stable prices and no demand tensions lead to very little profit being made by trading in and out of positions and, consequently, very low trading volumes.

Question 5. The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

Predictability and securitisations

PCS strongly agrees with the approach that sees 'qualifying securitisations' as securitisations where 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. Because of their ratings and the concomitant very low spreads, these bonds were purchased by investors who were not capitalised to absorb these totally unexpected losses and who were not set up to manage distressed portfolios. The attendant loss of faith in the rating agencies' capacity to assess securitisation risk also led to doubts over the robustness of all AAA securitisations, including those in Europe that we now know were robust. This led, on the one hand, to uncontrolled sales and substantial losses for sellers and, on the other hand, in a loss of confidence in institutions holding, or thought to be holding, instruments believed to be toxic. This, in turn, precipitated a financial crisis of confidence.

This somewhat oversimplified sketch of the crisis points to an important conclusion: the crisis flowed not from the default of securitisations but from *the totally unexpected default of securitisations believed to be extremely safe.*

It follows that the crisis would not have occurred in the manner it did had the risks embedded in securitisations been understood.[2] It therefore further follows that an approach seeking to define 'qualifying securitisations' as those where risk and pay-offs can be consistently and predictably understood is an appropriate

[2] This consultation is about securitisation and therefore this description does focus on the elements of the crisis that were centered on securitisation. We do not want in any way to imply that the sole root or even the main cause of the financial crisis of 2007/2008 was securitisations. This crisis was complex, its roots manifold and securitisation just one of the elements that played out.

response to the crisis. An attempt that merely sought to define 'qualifying securitisations' as bonds of a high credit quality, on the other hand, would not advance the debate much since it would neither draw the lessons of the past nor explain how, if such a method had been adopted in 2006, the outcome would have been any different from what actually came to pass.

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 high quality securitisations requires not just to understand 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 their inherent weakness?

PCS has worked on this this issue and reached the following testable conclusions: all securisation types that ran into unexpected difficulties contained one of fours 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: many securitisations whose underlying assets were originated by financial institutions that ran a pure "originate to distribute" model performed badly. This has now been recognised as the consequence of the dramatic decline in underwriting criteria that can result from this model. Such declines came from the replacement by some financial institutions of a long term funding credit analysis by a short term VaR analysis. This, in turn, resulted in a very strong lack of alignment in the interests of originators – generating and selling as many assets as possible without any quality concerns – and those of investors in securitisations – investing in the strongest quality assets.

    This does not mean that all securitisations produced under a pure "originate to distribute" model did fail. Nor does it seek to imply that a collapse of underwriting criteria is the inevitable consequence of any "originate to distribute" model. It is perfectly possible to devise internal rules or regulatory schemes that can prevent such a collapse within the context of an "originate to distribute" model.

    However, one of the lessons of the crisis is that securitisations produced under a pure "originate to distribute" model are, all other things being equal, vulnerable.

Pure “originate to distribute” models are also linked to lower confidence levels in the credit analysis. This is for three interconnected reasons:

a) Decline in underwriting criteria is easily overlooked by investors and rating agencies as it often takes the form of subtle changes in the behaviour of individuals within the originating bank. Even if seen, the exact consequences of these changes may not be accurately measured as they are new behaviours.

b) Most credit analysis is conducted on the basis of projecting forward past performance data. A decline in underwriting standards leads to what is, in effect, a change in the nature of the securitised asset. However, the asset continues to be categorised as the same asset that was being generated before the decline in standards and for which performance data is available. In other words, investors and rating agencies will most often continue to calibrate their analysis on a product (e.g. 1990’s US sub-prime mortgages) that, due to the dramatic changes in underwriting, no longer exists (e.g. 2004-2006 US sub-prime).

c) In securitisation, a decline in the credit quality of an asset should, in principle, lead the investors and the rating agencies to increase the required credit enhancement. So, for a bank that runs a pure “originate to distribute” model, any visible decline in underwriting standards should produce no increase in profitability since the increase in the required credit enhancement pushes up its cost of funding the new, lower quality, asset. However, if the decline in quality goes unnoticed (or the steepness of the decline is underestimated), then there is no increase in the credit enhancement (or a smaller increase than is warranted). Therefore, either through higher spreads or greater volume, the originator will increase its profits if it can lower the underwriting criteria without the decline being properly assessed. It is, therefore, not only the case that the pure “originate to distribute” model renders the originator indifferent to the credit quality of the assets it originates. The model creates positive incentives for the originator to hide or downplay the extent of the underwriting deterioration.

These factors make these types of securitisations much more prone to failures in the credit analysis as the risks in the assets are not correctly perceived.

(2) Iterative credit tranching: many securitisations generated through the application of iterative credit tranching failed (CDOs of ABS, CDO squared, CPDOs, etc…). Iterative credit tranching, in this context, means the creation through credit tranching of allegedly higher quality obligations through the

pooling of many lower credit obligations, themselves the product of credit tranching.

Iterative credit tranching results in very small changes in the credit performance of the underlying assets having substantial impacts on the credit performance of the securitisation. As such, these securitisations relied on a purported degree of accuracy in the measurement of credit risk (including issues of correlation) that proved highly illusory. Put differently, iteratively credit tranched securitisations are very vulnerable to model risk and the CRAs, as well as the market, placed unwarranted faith in the capacity of models based on limited data sets to gauge credit outcomes. This makes these securitisations both more prone to failures in the credit analysis and more fragile to even small unexpected deviations in credit conditions.

(3) Embedded maturity transformations: securitisations are, in the great majority, "pass throughs". The obligation to pay the holders of the securitisation bonds only arises when the debtors in respect of the underlying assets pay interest and/or principal. As such, they do not rely on a capital market refinancing to meet their obligations. A limited sub-set of securitisations did have embedded maturity transformations: structured investment vehicles and, to a substantial extent, commercial mortgage backed securities (CMBS)[3].

Securitisations relying on refinancing within a narrow window of time are vulnerable to market liquidity risks that are extremely difficult to model – if such modeling is even theoretically possible. As such they present specific and very difficult to quantify credit risks. They also did very badly during the crisis.[4]

This makes these securitisations not so much prone to failures of credit analysis but, in our view, very difficult to analyse robustly and extremely fragile to what are inherently unpredictable changes in the liquidity environment.

(4) Transparency: During the crisis it became clear that many investors did not have at their disposal sufficient information on the credit risks of their asset-backed holdings to perform a reasonable assessment. This led to massive

[3] PCS is aware that, as a technical legal matter, most CMBS transactions are "pass throughs" in that the underlying loan principal is passed on to the securitisation investors. However, since the funds for the repayment of these loans can only realistically come through a refinancing of this loan or the sale of the property, as a commercial reality, CMBS transactions contain real embedded maturity transformations.

[4] Asset backed commercial paper conduits also embed maturity transformations but the risks of these are usually taken out by bank liquidity lines. In the context of regulatory rules, the key issue is the treatment of these lines. Issue regarding ABCP conduits currently fall outside the remit of PCS and are therefore not broached in our response.

and uncontrolled disposals (or attempted disposals) generating substantial mark-to-market losses for financial institutions.

Lack of transparency can come either in the form of an absence of necessary data or in the form of complexity. When related to complexity, the data is available but either its quantity or the underlying complexity of the securitisation structure is such that even a sophisticated investor cannot derive a reasonable assessment of the risks of the instrument.

Usually, during the crisis, complexity has been associated with iterative credit tranching (e.g. CDO squared products based on CDO's of ABS).

The link between the lack of information and the fragility of credit analysis is self-evident and needs no laboring.

General comments on Box 3

The elements set out in Box 3 provide a definition of 'qualifying securitisation'. To the question of whether this is 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, that such a concept does have a floor. For PCS, that floor is determined by the four elements of structural weakness revealed by the crisis.

That being said, 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 elements above that, in our opinion, have been shown by the crisis to be key elements of safety 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!

We have also cross-referred to the items in Box 3 where relevant.

First Order Elements

The four structural elements which belong to the first order are those already set out in our analysis of the four issues that emerged from the crisis.

- Alignment of interest
- A single iteration of credit tranching (ie no re-securitisations) - ***para. 130***
- No embedded maturity transformation – ***para. 132***
- High levels of initial and ongoing disclosure – ***para. 140 to 143***

Second Order Elements

These include:

- Granularity - **para. 131**
- Homogeneous pools - **para. 131**
- Concentration limits
- Third Party due diligence - **para. 144 to 146**
- Certain legal elements (eg true sale) - **para. 135**
- Standard underwriting procedures - **para 131**
- No arrears or defaulted assets - **para. 132**
- 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.[5]

Trade-offs

In determining what elements should comprise the definition of 'qualifying securitisations' policy makers need to decide the purpose of the definition.

The definition could be used:

[5] http://pcsmarket.org/wp-content/uploads/2012/10/ElLIGIBILITY-CRITERIA-Version-7.pdf

(a) merely to cordon off the truly toxic products such as CDO squareds and CPDOs; or

(b) to define structurally robust securitisations which, when combined with an accurate and high credit estimation, could be suitable for conservative investors (including, potentially, retail investors) and/or for inclusion in regulation on par with similarly conservative products, such as covered bonds; or

(c) to 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 and an analysis on 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 those rules and negate the regulatory aims.

Modular approach (paragraph 102)

One way to deal with some of the issues around purpose and the attendant trade-offs is set out in paragraph 102 of the Paper: a core definition with additional rules to be added in specific regulations to account for the different emphasis and purposes of such regulations. PCS has strongly advocated and agrees with this approach, which we have described as a 'modular approach'.

We would, however, also caution against an approach that is 'too modular'. If the core definition of 'qualifying securitisations' is too slim and the number of additional rules for each regulatory purpose too substantial, the value of the core definition becomes lost as the products that have better regulatory treatment in the various schemes become extremely different from each other. The right balance will be key in this area.

Conceptual approach

One way to deal with the issue of certainty versus flexibility and of allowing development but avoiding gaming, is to adopt a conceptual approach. The conceptual approach seeks to determine fundamental characteristics that underpin structural strength based on an analysis of principles rather than only looking at past data and rejecting securitisations based on asset classes, jurisdictions or originator types which are associated with failed transactions.

This is very much the approach that emerges from Box 3 and PCS strongly agrees with this. It is also very much the approach that we have used in defining high quality securitisations for the purposes of the PCS Label.

Tranches

The PCS Label is only available for the senior tranches of securitisations. This is because our label was set up to define the very highest quality of securitisations. As we have mentioned above, this is not the only possible choice for a regulatory approach. We also note that, although the PCS Label only goes to the senior tranche, the PCS criteria if met in any transaction are definitionally met for all the tranches.

In other words, the conceptual approach to quality embedded in the PCS rules does not limit itself to the senior tranche. Therefore, we are very supportive of the Paper's approach to have a definition of 'qualifying securitisation' that can apply to all the tranches of a transaction.

Box 3 choices

Looking at the rules in Box 3, it would appear to us that the Bank of England and the ECB have chosen as a purpose the middle choice 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.

We also note, though, that the choices made in Box 3 indicate a desire to determine a certain level of structural strength that goes beyond securitisations 'where risk and pay-offs can be consistently and predictably understood'. For example, paragraph 128 seeks to exclude 'complex formulae and exotic derivatives'. This is sensible but complex formulae and exotic derivatives can be consistently and predictably understood, at least by those with the requisite quantitative skills.

We think this broader approach is made explicit in the language of paragraph 100 of the Paper. We also agree that this is the best approach. We do wonder though if this should not drive one to a slightly wider and more complete definition of ‘qualifying securitisations’ beyond consistency and predictability.

We also strongly agree, as stated above, with the modular and the conceptual approaches set out in the Paper. We also agree with a definition that applies to all the tranches of a transaction. (Indeed, the modular approach can then come in when only the senior tranche is deemed appropriate for any given purpose.)

We believe that labels that seek to define best practice have an important role to play in reviving the securitisation market but that these ‘best practice’ labels are complementary to a definition of ‘qualifying securitisation’. As we set out in our responses to questions 6 and 7 below, we believe this complementarity can run very deep.

Specific comments on Box 3

Looking at the specific recommendations set out in Box 3, we would have the following comments:

Para. 128: We are not sure what this paragraph seeks to capture. We believe it may seek to eliminate assets, such as commodities, where one needs to rely on a market sale of the asset. However, if this is the case, it may double up with paragraph 132. We agree with the complex formulae and exotic derivatives.

Para. 129: We agree.

Para. 130: This seems to seek to eliminate re-securitisations and synthetic securitisations. As stated above, we agree with the former.

The latter is a more intriguing issue. PCS believes that at least two types of transactions called securitisations have very different credit dynamics from traditional term securitisations[6]. These are (a) synthetic securitisations and (b) asset-backed commercial paper conduits (ABCP).

The PCS label is not available to either of these products. However, this does not reflect the fact that they are, in our view, bad products but rather that they are different products with different rules and risks.

[6] In fact, the definition of ‘securitisation’ used in European regulation, depending on its interpretation, can capture a number of transactions that the market and regulators would not consider to be securisattions. Certain bi-lateral bank loans with senior/sub structures are an example. This is a wider issue that should be looked at but is not the subject of this consultation. The issues relating to synthetic securitisations and ABCP though are important and should be mentioned.

Therefore, although we agree that it may be sensible to have rules for ‘qualifying securitisations’ which effectively or explicitly eliminate these products from the category, we are not sure that this should result in these products simply becoming grouped together with genuinely flawed securitisation products such as CDO squareds. This appears to us to be a form of guilt by association. It may be better to exclude these products from this analysis altogether and seek, arduous as this may be, to define rules for “qualifying synthetics’ and ‘qualifying ABCP’.

PCS would be willing to assist in this, although we agree it would be a longer term project.

Para. 131: We are broadly in agreement.

Para. 132: We agree, although we believe this criterion covers two very different issues and would benefit from being split into two.

Para. 133: We are not sure about this. If a securitisation with unsecured assets can be a ‘qualifying securitisation’, we are not sure why a securitisation with secured assets requires these to be first ranking. The PCS Label requires this for RMBS but as a ‘best practice’ for residential mortgages. We are not sure that this makes as much sense as a general rule. For example, this rule would exclude an SME securitisation where you have the benefit of a second charge when the same transaction would qualify if you had the benefit of no charge at all.

Para. 134: We agree that, within the rules of a conceptual approach, the list of assets eligible for ‘qualifying securitisation’ designation should be non-exhaustive. This also requires that mechanisms be in place to bring new asset classes within the definition of ‘qualifying securitisation’ when appropriate and on a robust basis.

Para. 135: PCS agrees with the general approach but would like to caution that, as drafted, this will be very complex to verify. The notion of "true sale" is the subject matter of legal opinions in each transaction that run to fifty or more pages, contain literally dozens of assumptions on which the opinion is based and further dozens of qualifications that modify the statements in the opinion. The rating agencies, over many years, devised rules and protocols to determine what they would accept as a "true sale". These are not the same from agency to agency. If this is incorporated in the definition of ‘qualifying securitisation’, the regulators could well end up forced to do the same. This may either render the definition unusable for banks or force lengthy and contention regulatory technical standards. PCS has addressed this in its criteria in a slightly different way that could be clearer and easier to use[7].

Paras. 136 to 144: We are broadly in agreement.

Para. 145: We agree as a general matter but are not sure what the term 'verified' is seeking to cover.

Para. 146: We agree.

Missing items?

Alignment of interest: We saw no reference to retention of economic interest by the originator. This PCS considers crucial.

Concentration limits: PCS believes that granularity is important (and referred to in paragraph 131). However, without concentration limits, granularity can be easily circumvented by having a large portion of the total pool concentrated on very few or even a single asset.

'Pool audits': In the paragraphs on external verification (144 to 146) there is no reference to a third party verification of the assets prior to the securitisation, usually refered to as a 'pool audit' (to the great unhappiness of accountancy firms). PCS believes that such a verification is an important aspect of the due diligence process.

'One payment requirement': Most securitisations require that at least one payment has been made on the securitised assets prior to securitisation. (With appropriate modifications of the rules for credit card transactions which operate on slightly different principles). PCS believes this is an important, if not crucial, badge of quality.

Question 6. Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?

Question 7. These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?

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[7] These may be found in Criteria 1(g) of the PCS Label criteria (with equivalent provisions for The Netherlands and the United Kingdom in the relevant sections). See http://pcsmarket.org/wp-content/uploads/2012/10/ElLIGIBILITY-CRITERIA-Version-7.pdf

We are responding to both Question 6 and 7 together.

Certification in the context of regulation

The importance of a 'qualifying certification' in the context of 'qualifying securitisations' lies, we believe, in a regulatory dilemma. Assuming that the concept of 'qualifying 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. As we have stated, there are 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 'qualifying securitisation' towards a fairly complex set of conditions.

On the other hand, the more complex a regulatory scheme the harder it is for regulators to manage but also for the market to handle. The additional compliance burden can lead investors (or originators, depending on where the burden falls) to turn away from the product – especially if alternative investments can be found which are free of such burden.

This is the regulatory dilemma: make the definition too simple and it will not capture all the elements that need to be captured (and likely be susceptible to gaming); make it too complex and the additional regulatory uncertainty and burden means that no market emerges.

It is in this context that a 'qualifying certification' can bridge this gap.

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

(a) no certification

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

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

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

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

Ultimately, no doubt, unofficial lists of ‘qualifying securitisations’ would probably start to circulate and regulators will be pushed to make public statements regarding the definitions. But this is extremely inefficient and cannot help with new issues.

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

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

(b) a self-certification process

Under this scheme, the originators would certify that the securitisations issued by them 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.

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

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

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

(i) universality

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

(ii) timeliness

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

(iii) cost effective

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

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

(d) a private sector entity

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

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

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

(i) no 'privatised' rule-making

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

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

A similar approach is well established in European law with the 'notified bodies' who are entrusted with the verification of many sensitive items from medical equipment to air traffic control[8]. The extension of this concept of 'notified bodies' with its extensive set of rules and precedents within European law to finance seems a promising way forward.

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

(ii) No conflicts of interest

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

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

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

(iii) Transparency and accountability

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

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

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

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

8 http://ec.europa.eu/enterprise/sectors/construction/declaration-of-performance/notified-bodies/index_en.htm#h2-1

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

One is regulatory economies of scale. If, as mentioned, there is a core definition of 'qualifying securitisation' with additional elements to cater for the differing aims of distinct regulations, a private certification agent, looking at the same securitisation could incorporate all the various criteria in a single certification. This would create a certification that allowed different types of investors to be able to rely on a single list of securitisations that met the different rules. Alternatively – or in addition – such a certification agent could look at a securitisation once and give a number of certifications reflecting the various regulatory requirements. For example a transaction could receive certificates for 'qualifying securitisation - Solvency II', 'qualifying securitisation – LCR" but not 'qualifying securitisation – MMF'. The existence of this information in a single location would be strongly beneficial, in our view, to a liquid secondary market. This would avoid duplication of work and so lower costs and increase efficiency.

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

Certification in the context of investors and liquid markets

Although current low issuance reflects a lack of supply rather than demand, it is clear that for securitisation to play its role in funding the real economy, issuance will need to grow very considerably. In our view, based on conversations with market participants, we suspect that there is enough headroom, amongst existing investors, for a European market issuance of maybe up to €160bn. But for the market to grow to the €400bn plus mark of annual issuance, new investors will need to be brought in.

Investor trust in the product

We believe that the fact that securitisation can be very robust is now generally understood. However, this is also true of the fact that securitisation of the wrong kind can be very dangerous. Therefore, a condition for bringing in new real money investors is to be able to demonstrate, in a tangible way, that what they will be investing in (and, more importantly, what will be invested in on their behalf) are the robust securitisations and not the dangerous ones. This requires both a credible explanation as to the difference between the former and the latter and a way of being to demonstrate that only the former are in their portfolio. But because securitisations, like many other financial products, can be complex and the distinction between the former and the latter are not immediately obvious (such as a false statement like “mortgages are good but ship loans are bad” or “short term is good but long term is bad”, etc…) it will be difficult to build this trust. The real money investor handing cash to an asset manager or hiring a credit analyst to buy securitisations on his or her own account cannot be expected to read the 300 plus page prospectuses delivered by most transactions.

This is where a definition of ‘qualifying securitisation’ and/or a definition of ‘best practice’ incorporating, inter alia, such definition together with a credible independent certification agent can be a powerful tool in rebuilding this trust.

This analysis also provides a response to one of the oft mentioned concerns with a ‘qualifying certification’: does such a certification not run the risk of substituting for proper credit analysis by investors? This is indeed a very legitimate question. But it also tends to treat the “investment decision’ as a single act. In reality, one needs to distinguish between the “investor” who makes the individual purchasing decision: do I buy bond X at 45bp or bond W at 33bp? and the “investor” in charge of strategic decisions: do I allocate 5% of my funds to ABS or do I allocate 15%? The former will continue (and must be required to continue) to do fundamental underlying analysis of each securitisation he or she purchases. But the latter is the person for whom an independent certification makes sense as a trusted macro filter for fund allocation.

Standardisation

Also, a continued process of standardisation in the European securitisation market would be very likely to assist investors and the deepening of a liquid market. The experience of the Dutch Securitisation Association shows that a private sector initiative, such as the DSA or PCS, is a very good vector to achieve progress in this area. Left solely to the industry, this process is more likely to stall through the lack of any industry “champion” willing to dedicate the resources and time to the project. Driven by regulators, the process risks becoming unnecessarily adversarial. The use of an entity that has a strong role in the markets as certification agent for ‘qualifying securitisations’, is trusted by the regulatory community through the ongoing contacts such role would require and was trusted and known to the industry through its labeling activities seems like a most appropriate body for this task.

Benchmarking

PCS has been told repeatedly by fixed income investors that the lack of benchmarks in European securitisation is a major disincentive to investing in the asset class. The existence of a recognised ‘best practice’ label with a regulatory role would be a powerful and self-evident anchor for the creation of benchmarks and indices. This could be achieved, of course, without the role of certification agent but such a role would make the use of a label such as PCS (and others) a more compelling proposition.

Question 8. Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?

PCS believes that a pan-European harmonisation of data reporting is to be welcomed. We believe that harmonisation rather than software solutions would be preferable. We would not, however, claim that this is a necessary or even crucial element in restarting the securitisation market.

On improving access to existing loan level data, we believe that this is a matter best left to investors to comment. We would, however, relate two points made to us by investors. We are aware that investor use of loan level data appears sparse. However investors have told us that they make use of the models and tables produced by specialist services (Bloomberg, Lewtan, Intex and others). These services use the available loan-level data. Therefore, the sparse use by investors may be hiding the fact that many investors use the data indirectly.

Secondly, investors have made to us the point that, even if they do not use the loan level data regularly, the knowledge that it is available and could be consulted if transactions started to display negative developments is an important aspect of their confidence in a securitisation. In other words, low usage should not be read to imply that there is a problem with the availability of loan level data.

Question 9. Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?

PCS believes that the standardisation of prospectuses, investor reports and, ultimately, deal documentation would be of great benefit for the growth of a robust securitisation market. We are aware that the diversity of assets, legal rules and insolvency rules places a natural barrier on how much standardisation could be achieved. However, the work done in the Netherlands by the DSA and in the UK by RMBS issuers under the impulse of PCS demonstrates how much is still achievable.

We do believe though, as set out in the last part of our response to question 7, that an independent private sector entity such as the DSA, the TSI or PCS is best placed to champion such work, working in close co-operation with both industry and the regulatory authorities. Ultimately, the possibility of regulatory action to enforce or prefer standardised approaches can be of great value, but it may not necessarily be the best starting point.

We should also stress though that, as with data reporting, this is not a necessary or even crucial element is restarting the securitisation market.

Similarly, the location of all documents in a single place can only be of benefit, but should not be seen as a ‘game changer’.

With regard to the issue of pre and post-trade transparency in OTC trades, this is a matter that falls well outside the area of defining high quality securitisations and into which PCS has neither the knowledge nor the mandate to stray. We shall therefore leave comments as to these issues to those who understand them better than we do.

Question 10. Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers ' confidentiality is preserved?

At the behest of the European Investment Bank, PCS led a working group on the issue of a pan-European data gathering exercise to assist SME lending generally and securitisation in particular. The report is currently with the EIB. The conclusions that were reached by the working group were in the context of SMEs but are probably broadly applicable to most other asset classes.

The conclusions were that the availability of such data would be positive for the market, but only if the data was in a form that allowed for the estimations of PDs, LGDs and correlation. The raw data would not be of much use.

The impediments to such data being made available were that it was not clear that any meaningful LGD data was available outside the banks. Even within the banks, there was strong doubt as to the existence of such data. Another problem was the lack of common definitions. This made such data impossible to compare without a re-formatting into a set of common definitions. Such a task was very costly and difficult.

The quality of the data in a number of registers was open to discussion. Issues of borrower confidentiality though did not seem to be overly prohibitive.

The overall conclusion was that such project would be good for the securitisation market, but would take a number of years to be completed, would require the involvement of one or more regulators or policy makers, would be very complex and controversial and would be costly. The cost benefit analysis would need careful consideration.

Question 11. In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-

economic data were disclosed or if banks/ non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

We defer to the investor community on this matter.

Question 12. Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

We refer you to our response to question 7. The technical issues around benchmarking are not issues PCS feels best placed to answer and so we would rather leave this to others rather than speculate.

Question 13. Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

Any additional information is positive for investors. So the information mentioned here could play a positive role. However, PCS has looked into this issue in the context of its own labeling rules and we would extend a few words of caution.

First, the different CRAs have different ways of approaching the issue of what the rating of a securitisation would look like without the sovereign cap. This is not an easy concept. Therefore, great caution would have to be exercised in defining exactly what these alternative ratings meant. To the extent that they meant different things for different agencies, they may be prone to becoming misleading. (Arguably, the same can be said of the ratings themselves).

Secondly, the impact of the disappearance of a provider of an ancillary facility can be very different depending on the exact nature and terms of the facility and the identity of the provider. Again, great care needs to be taken that investors do not misunderstand the information that is provided.

On balance though PCS would be in favour of such information being available.

Question 14. How important do respondents see the impediment related to the availability of ancillary facilities?

We believe that it is a serious issue for the markets but we have no specific knowledge and would rather originators provide a more accurate picture.

Question 15. Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

The creation of such bank accounts would be a major benefit. As to whether they would outweigh the costs depends very much on how such accounts are to be achieved. In the United States, PCS understands such accounts are known as 'trust accounts' and involve matching deposits with the Federal Reserves. Such deposits can be pledged to the SPV. A solution that involved the central bank opening an account for an SPV or an account for the originator and allowing an effective pledge of such originator account seems potentially the easiest route. Whether this is possible would require an analysis of the constitutive documents of central banks and the modalities of pledges of bank accounts under local law. A solution that required changes to primary insolvency legislation could be considered difficult to engineer.

No other initiative of similar nature comes to mind at present.

Question 16. With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?

Limiting concentration (paragraph 96) - Correct calibration of banks' securitisation exposures is vital

PCS agrees that it is desirable, from a macro-prudential point of view, that banks do not hold an excessive proportion of the market. This is not only important to strengthen the resilience of the financial system – by having securitised assets held by less leveraged investors. It is also important to rebalance European finance away from its very large dependency on bank funding toward a more US style reliance on the capital markets. This point is made in paragraphs 41 and 42 of the Paper. PCS strongly agrees with this view.

However, we also believe the point made in paragraph 73 of the Paper - regarding the punitive and, in our view, unwarranted regulatory cost of banks holdings of securitisations - is not only entirely correct but also very important. We view it as a key point for the development of a future European securitisation market.

In line with the desire to rebalance the European financial architecture, it is usually posited that policy should encourage securitisation as an alternative to bank funding. However, one then sometimes hears the argument that if this is the case, why should policy makers concern themselves with potentially punitive treatment for banks as investors in securitisation? If securitisation is to be an alternative to bank funding, then should policy not encourage banks to issue securitisations but discourage them from holding them? First, we think this is an oversimplification of the benefits of securitisations when held by banks. But more importantly, the entry of capital market players in this field will crucially turn on the belief by new investors that securitisations are not an illiquid asset. For this, a market needs to be made in this asset class. This is only a realistic prospect if banks are not heavily punished for holding this asset in their trading book. ***It is therefore precisely because we need non-banks to buy securitisations that banks should not be unfairly penalised for holding them.***

This is not, of course, to suggest that proper prudential requirements for banks' holdings of securitisations should not be in place.

Synthetic securitisations (paragraph 96)

As we have indicated above[9], PCS does not label synthetic securitisations. However, we feel that it may be unfair to describe them as 'more opaque'. Although this is not an issue that is of direct concern to PCS, we would aver that synthetic securitisations are not intrinsically opaque but, being so more fundamentally defined by the drafting of their documentation, must be approached very differently. As such we agree, as we have said before, that they cannot easily, if at all, fit in a sensible definition of 'qualifying securitisation'. However, appropriately used, they can be useful tools to lessen systemic risk in the banking sector. With much stronger standardisation of documents, we could see benefit in the creation of a robust 'qualifying synthetic transaction' definition.

Question 17. Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

In paragraph 100, the Paper speaks primarily of the benefits of a definition of 'qualifying securitisation' in assisting investors. In paragraph 102, the Paper does suggest that 'qualifying securitisation' may also play a role in regulation. How the definition might be deployed is not set out in detail. We would therefore take the opportunity of this question to set out a possible, and in our view optimal, way in which this could be done.

Regulatory bifurcation

It is a basic tenet of prudential regulation that, when regulating an asset class or a class of activities, the regulation must be calibrated by taking into account the worst performers or most dangerous types of the class of assets or activity. Otherwise, the regulation fails to protect the public from bad behaviour since the calibration is set too low. But this becomes a problem when you have an activity

[9] See our specific response to Box 3, paragraph 130

which is (a) important and/or useful and (b) has a substantial proportion of the asset class (or activity) that is very safe. This is what has happened to securitisation in many of the regulatory proposals that have been or are in the process of being implemented.

The way in which this conundrum is dealt with in regulation is by identifying the sub-category that is safe and bifurcating the regulations between those that apply to the safe asset or activity and those that apply to the others.

Put simply, if they do not identify the characteristics of high quality securitisation and bifurcate the regulations to treat these in accordance with their actual risk characteristics, policy makers have literally no choice but to regulate the entire field as if it were all US sub-prime. This is why PCS was set up – to identify high quality securitisations – and why we have advocated this regulatory bifurcation since our inception: not only is it theoretically correct but it is the only way to have prudent regulation that does not shut down the whole European securitisation market.

This is also why we welcomed the decision of the European Commission and EIOPA, when crafting the Solvency II rules, to seek such a bifurcation. Similarly, we understand that this approach may be extended to the definition of HQLA.

The search for a definition of 'qualifying securitisation' follows similar lines.

Unified definition

In order for securitisation to bridge the gap between bank and capital market funding though, it is also important that the various regulatory schemes governing different potential investors (banks, insurance companies, pension funds, asset managers and retail customers) should be sufficiently similar as to create a unified market.

If the way each group's regulations are bifurcated between high quality securitisations and other is very different, then the market cannot grow as insurance companies cannot economically purchase the assets that can be held by money market funds who cannot sell their holdings to banks.

At the same time, PCS acknowledges, as does the Paper in paragraph 102, that different regulations serve different purposes. A definition of 'qualifying securitisation' that sought to capture each and every single regulatory requirement would end up setting the bar far to high being the highest common denominator for every possible investor and regulatory aim. But separate definitions for each regulation will fragment the market as mentioned above.

Therefore, PCS would advocate a single, conceptually based, definition of 'qualifying securitisation'. This definition could be set in European law as are many others, such as 'securitisation' itself or 'SMEs". This 'qualifying securitisation' definition could then be used in every regulatory scheme that deals with securitisation. Each regulatory scheme could then add additional requirements that spoke to that scheme's specific aims. This is the modular approach we referred to earlier in our response.

We believe that the European authorities should also seek to globalise this definition, through such bodies as the BCBS, the FSB and IOSCO. We believe strongly that the approach suggested in Box 3 is one of universal applicability.

However, we would also draw once more attention to the fact that the European market is in peril and that time is of the essence. Recognising the arduous and time consuming nature of global regulation, we would urge in the strongest terms that Europe take the lead in this matter within its own regulations.

Other policy options

We believe that, if one accepts that a definition of 'qualifying securitisation' can be crafted that represents a simple, safe and transparent investment, then a key aim of policy should be that such investment be treated on par with other similarly simple, safe and transparent investments, such as covered and corporate bonds.

This would mean equalising the treatment of these different products whenever justified. This would include, in our view, removing some of the punitive due diligence requirements in the AIFMD and opening 'qualifying securitisations' to retail investors though funds (UCITS rules) – with the appropriate safeguards that are always and rightly required for retail products. As the European institutions looks at the rules around money market funds and the application of Liikanen report, a definition of 'qualifying securitisations' should also play a positive role.

Question 18. Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?

Direct lending and whole-loan purchases

One way in which it is sometimes thought one could rebalance the European financial architecture toward a greater role for the capital markets is to induce capital market players, such as insurance companies, into direct lending or the purchase of whole-loans.

There is nothing intrinsically wrong with this. However, when one gets to very granular products, such as residential mortgages and SME lending, this approach becomes quite difficult.

This point is made in paragraph 43 of the Paper. PCS believes that the point that, for certain types of lending, banks are arguably better placed that other types of investors to extend credit is very well taken. We would go a little further and suggest that, for most of these types of loans, the only way in which insurance companies, pension funds and similar types of capital market investors would be able to enter these markets without incurring unacceptable levels of risk, would be to replicate the credit underwriting systems and origination networks of banks. This, we would suggest, would merely result in the creation of “shadow banks” with all the risks (systemic and otherwise) of existing banks. This, in turn, would require regulatory approaches that equated “banks” and “shadow banks”. In other words, this would not really represent the entry of capital market players into the financial architecture of Europe but merely the creation of more ‘banks’ within the same architecture. PCS does not therefore feel that this alternative to securitisation would be much of a positive component of a potential rebalancing of finance.

Question 19. Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?

We refer you to our answers to question 5.

Unintended consequences

Any bright line definition of ‘qualifying securitisation’ will automatically create a set of securitisations that are ‘in’ and a set of others that are ‘out’. This is not only natural but also necessary if we wish to see the necessary bifurcation of regulatory approaches.

However, it is simply not the case that everything that is not a ‘qualifying securitisation’ (or, for that matter, eligible for the PCS Label) is a ‘toxic’ product. They are many securitisations that will not meet the definition but will be perfectly good capital market products. Indeed, they are likely to be better than some other higher risk capital market products that are widely traded.

The risk, which we feel may have obtained in the case of the calibrations proposed in Solvency 2 for Type B securitisations, is that a strong focus on defining high quality securitisations, leads to those that do not meet the definition to suffer a form of benign neglect.

Although containing more complex risks that make them more suitable for the more sophisticated investors able to understand them, some of these securitisations can have a positive role to play in the funding of the real economy. We therefore strongly recommend that the defining of ‘qualifying securitisation’ does not lead real economy products that fall outside to the definition to be ‘thrown to the dogs’. These should be the subject of appropriate calibration in the regulation and not automatically badged as ‘toxic’.

This is even more true of types of securitisation, such as ABCP, that cannot meet the definition for technical rather than fundamental reasons.

Another concern we have already mentioned is that securitisation, like most financial products, evolves over time to meet new opportunities and new economic realities. In the context of a definition of 'qualifying securitisation' that is embedded in regulations this may also involve a negative development where market participants seek to game the rules.

To avoid closing down positive new developments and to guard against attempts to game the rules, the ultimate structure of the definition will need to contain the possibility of adaptation that is not too onerous. Again, this is an area where an independent certification agent could play a positive role, under the control of the public authorities.

CONCLUSION

Once more, PCS would like to thank the Bank of England and the European Central Bank for a timely and extremely well designed consultation. We believe that work of this nature, including similar work being done by the European Banking Authority and the joint IOSCO/BCBS committee will play a key role in devising a better regulatory architecture for securitisation: an architecture that learns from the lessons of the crisis and can underpin a strong, safe and substantial securitisation market able to fund the European economy.

We urge all stakeholders in the public and the private spheres to work swiftly towards such a new architecture. As the European securitisation market continues to shrink, its revival will depend not only on such an architecture but also, in the interim, on clear indications from regulators and policy makers that work to achieve this end is taking place and can be delivered within a reasonable timeframe.

PIMCO

Please find below our main points regarding your Discussion Paper -

"The case for a better functioning securitization market in the European Union"

- We see a non-discriminating regulatory environment as essential for a revitalization of the European securitization market. Senior tranches should face similar capital charges for banks and insurance companies compared to other funding instruments like Covered Bonds.

- AIFMD creates a burden on investors and might reduce investor participation into the asset class. We agree on the usefulness of the minimum retention rule and also see a proper due diligence of ABS investments as essential. Nevertheless, any formal and qualitative standard requirements for the due diligence process are seen as unsuitable given the diverse universe of structures and underlyings. The due diligence criteria are unable to provide any specific guidance if an investment is appropriate. For example, they don't address the fact that less granular pools and/or weaker collateral can be offset by higher credit enhancement levels. Weaker pool /servicing/originator quality could also be addressed through higher interest rates/spreads of the securitized bonds. Particular investor groups are certainly willing to take higher risks for higher expected returns.

In the German fund industry the "Kapitalanlagegesellschaften (KAG)" are responsible to comply with the AIFMD rules. In cases where the ABS portfolio management is outsourced to a specialist third party manager the KAG typically does not have the necessary resources/know-how to comply with the AIFMD requirements and might restrict investments into securitizations in general to avoid the risk of being non-compliant.

- A key element for a successful revival of the market in Europe from our perspective would be the appropriate protection of investor's rights and interests in securitizations. Clear rules to limit for example the servicer's discretion to modify securitized loans at the cost of investor's are essential. The role of trustees needs to be more clearly defined to ensure trustees act timely and solely in the best interest of the investors and are fully accountable.

- We agree on the point that further standardization of underlying pool data and surveillance data/information is desirable (European data warehouse certainly an important step towards this goal), though we don't see the need for a full general standardization of structures/transactions and are less concerned about certain risks like call risk or rating migration. Imbedded risks in transactions can be priced accordingly and offer investment opportunities dependent for different types of investors and their individual risk tolerance and risk/return targets.

- We think that liquidity is a function of issuance volume (size of issues/tranches, market volume in specific segments/sectors and the overall publicly placed ABS market volume). Liquidity is one component of the overall risk (in addition to pool risk, servicing risk, structural risk, etc.) of an ABS investment. Investors might have different preferences for liquidity and might be interested to take on more illiquid positions if illiquidity is priced appropriately.

• Demarcating a subset of the European securitization market as "qualifying securitizations" seems to be a suitable way to enable policy makers and regulators to treat especially senior tranches appropriately. We see the risk that the definition of qualifying securities could be somewhat arbitrary given the relatively long list of criteria. The effort is useful to revive the asset class and to eliminate the negative stigma that had hit the asset class after the financial crisis in 2007/2008, though we think there should be room for a segment of non-qualifying securitizations where the market defines a clearing price for funding and risk transfer dependent on investor's risk/return appetite without overly harsh regulation and policy influence.

• We support the initiative for more transparency and facilitation of detailed pool information. Credit registers would only be helpful if they would be consistent across jurisdictions. Credit information on borrowers could be a supplement to loan level information and would be helpful in the investors' assessment of the underlying pool risk. In terms of priority, we would rank necessary efforts to improve "consistent and high quality" loan level information in the European data warehouse higher and more important than starting with new credit registrars.

• Instruments "to trade an index" might be useful and could be established based on market forces if volume and homogeneity of specific sectors develop appropriately. We don't believe that trading instruments on an index can be established at an initial stage. Saying that, simple cash indices (like the Barclays Euro Floating ABS Index) that cover the senior market appropriately and provide price and return information of the asset class on a regular basis are certainly useful and important.

RESERVE BANK OF AUSTRALIA

At the G20 Deputies' meeting in Melbourne, G20 members were asked to provide comments on the BoE/ECB paper 'The case for a better functioning securitisation market in the EU'. While acknowledging that this paper is targeted towards the EU, the 'Principles of qualifying securitisation' (Box 3) seem to have the potential to extend outside the EU, and it is in this spirit that we offer the following comments:

Our main concern with this paper is the implied suggestion in the paper that 'qualifying securitisations' would be expected to receive preferential treatment in central bank operations, amongst other preferential treatments. Ultimately, margin requirements for central bank operations should be set by the central bank to reflect its assessment of the risk of the collateral rather than being based on whether a security meets a set of principles.

Detailed comments on Box 3:

- The overall discussion on what constitutes a 'qualifying securitisation', in the sense of identifying securitisations where simplicity, structural robustness and transparency enable investors to model risk with confidence, seems broadly appropriate.
- The Australasian securitisations market tends to have simple securitisations and our interpretation of the principles, both the collateral and structure, is that Australian securitisations would meet all/most of them. This includes the composition of collateral (in Australian securitisations the assets are typically residential loans and other granular receivables with predictable cash flows and not derivatives linked claims or other securitisations) and the structures (which in Australian are well defined, and quite simple, at the time of the securitisation).
- However, there are a couple of points that would be at odds with Australian securitisations and we argue that these points do not aid in identifying simple and transparent securitisations:
    - Paragraph 128 suggests that that interest payments on the securitised assets should reference commonly encountered market rates. It is a bit unclear what this exactly means but in the case of Australian RMBS, loans are for the most part variable rate loans with an interest rate that is specific to the loan and not tied to a particular market reference rate. This in itself should not make it any more difficult for investors to assess the securitisation or diminish the transparency and simplicity of the securitisation.
    - Paragraph 129 suggests that performance data on assets that are the same as the underlying performance should be made available covering at least one period of significant market stress. It is not clear what significant market stress means, but for securitisations with collateral that has performed well historically (e.g. Australian RMBS) this may mean going back a few decades to find a stress period. Even if such data is available its relevance for the performance of the current collateral is low due to the likelihood of structural changes over time that diminish the usefulness of past data to predict future performance. This principle would seem to have the potential to penalise securitisations with collateral that has historically performed well.

  - Paragraph 132 suggest that only current collateral should be included, not delinquent loans. It is not unusual to include small part of slightly delinquent collateral especially in non-bank issued securitisations. Excluding such collateral completely may penalise these issuers without adding anything to the ability of investors to 'model risk with confidence'.

- The box discusses transparency as another aspect of 'qualifying securitisation'. For background, the RBA has put in place steps that will greatly increase the transparency of Australian securitisations, including regular reporting of collateral, structure (including cash flow models) data, as part of its initiative on data reporting for RBA repo-eligible asset-backed securities and the associated public reporting of the data.

Regards,
Emily.

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04 July 2014

By email

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Dear Sirs,

The case for a better functioning securitisation market in the European Union Discussion Paper

RBS welcomes the publication of the above discussion paper and is pleased that the paper acknowledges that securitisation can be a useful tool for financing the economy. Our response below sets out the benefits of a better functioning market and what key changes, in addition to those discussed in the industry responses, are required to the regulatory framework surrounding securitisations to ensure it functions better.

Benefits of securitisation

There are many benefits of securitisation, not just in managing a bank's own funding and capital, but the knock on effects these benefits can have on customers and wider economy.

Securitisation is one of a range of funding sources available to banks. It is important for banks to have various funding sources available to it and the flexibility to move between different sources of funding to meet changing requirements. It is also an important source of funding of term assets, as it permits the matching of certain characteristics of the loans and funding, for example tenor and interest rate risk. Any mis-matches are effectively passed on to investors.

RBS considers that, with further developments to the securitisation market, the liquidity of securitisation positions could increase. There have been many improvements made to the securitisation market since the crisis, particularly on retention requirements, disclosure and due diligence, which have lead to much more transparency. However there are still further steps which could be taken, some of which are outlined in this paper, for example the introduction of 'qualifying securitisations' which may assist the liquidity of securitisation issuances. RBS welcomes initiatives which further enhance transparency and 'qualifying securitisations' may be able to provide additional information through standard disclosure on the asset quality of pools, where the assets within those pools are fairly standard in nature, resulting in clearer pricing. However, care needs to be taken for liquidity not to be confused with trading volumes; the current low trading volumes are as a result of a lack of supply, rather than a lack of buyers. Given the relatively limited supply of securitisation paper, investors tend to buy and hold.

In order for banks to be able to increase lending, they must be able to use securitisation as an effective capital management tool. Recognising appropriate capital relief, in line with the reduction in risk, will result in the only tangible increase in lending. Effective capital management can result in more competitive pricing passed onto customers.

Regulatory Framework

The regulatory framework surrounding securitisation has been subject to various regulatory initiatives since the introduction of Basel II. These changes have often been to address specific issues identified;

however in order to fully capture the benefits of securitisation to the wider economy, a more fundamental review of the regulatory framework is required, starting with some of the definitions used within the framework which have a significant bearing on how the framework is applied and the outcomes for banks and the real economy.

In particular, the current regulatory definition of securitisation is ambiguous and can result in the application of the rules to transactions which it is not designed or intended for e.g. acquisition finance, single loan structures and secured corporate lending. This can result in an unwillingness to lend to certain sectors due to the regulatory risk of the framework being applied and potential differentials in capital outcomes between the securitisation and non-securitisation frameworks. Having a clear, unambiguous definition should decrease some of the uncertainty which affects the liquidity of securitisation positions and make the introduction of 'qualifying securitisations' simpler.

There is similar ambiguity in the originator definition which also should be addressed. For example in third party managed Collateralised Loan Obligations ('CLO') transactions, loans are sourced from various primary and secondary sources, rather than a single originator, during the ramp up period. Post close the CLO manager will trade in and out of loans maximising the return for the noteholders and themselves via management fees. Again, these loans will be bought from various sources, including through the secondary loan trading market. Banks will be selling loans to asset managers, and only the settlement instructions may indicate that these are being sold directly into one of the asset manager's CLO transactions. This example highlights the importance of these definitions and the need to consider the effects of them on other parts of the regulations, in particular retention requirements and significant risk transfer ('SRT').

Retention Requirements

RBS is supportive of the purpose of the EU's securitisation retention requirements; however consider that the rules need to take a more principles based approach, to enable the rules to be applied more appropriately to less straightforward transactions. As currently implemented the retention rules are too rigid to permit retention by the most appropriate party considered in certain transactions. For example CLO transactions not only have problems with the originator definition, as highlighted above, but, there are also issues for CLO transactions where the asset manager does not meet the definition of sponsor; often, the asset manager is the most appropriate party to retain. Similarly, there are transactions where whole businesses are being bought, funding the assets using securitisation, but overly-complex structuring is required to enable the purchaser of the business, whose interests are those most aligned with the investors, to fulfil the retention obligations. These issues can cause difficulties for challenger banks and alternative non-bank lenders entering the market and increasing competition and lending supply.

SRT

As discussed above, securitisation to manage risk and capital is an essential tool to enable banks to increase lending to the real economy. Without recognising SRT, securitisation will not lead to an increase in lending as it will not result in either a reduction in the bank's capital requirements or a reduction of assets for leverage ratio purposes.

The CRR permits the recognition of SRT, but essentially the power rests with the competent authorities to grant capital relief. RBS understands and is supportive of the rationale behind this; however, in order to facilitate a growth in the market, it requires a similar positive attitude towards securitisation, and an appreciation of the need to work within commercial timeframes, from the competent authorities.

RBS is happy to engage with you further on this matter.

Yours faithfully,

David O'Loan
Global Head of Treasury Markets

RiskControl
www.riskcontrollimited.com

Response to the Bank of England-ECB Consultation on the EU Securitisation Market

Date: 04-07-2014
Number: 14-67a

This document sets out RCL's response to the joint Bank of England-ECB discussion paper entitled "The case for a better functioning securitisation market in the European Union" dated May 2014.

Please note that we are currently preparing a detailed paper on appropriate principles for defining "qualifying" or "High Quality" securitisations and how such a definition or label could be used in assigning preferential treatment within capital and liquidity regimes. The responses listed below draw in part on that forthcoming paper.

Question 1. Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?

Section 2 of the discussion paper sets out benefits that securitisation can offer as a funding tool, a means of transferring risk, as a means of enhancing liquidity and as a means of generating high quality collateral. We agree with this description but find that these arguments are at a somewhat "micro level". What is not recognised by the discussion is the more "macro", single-market role of securitisation.

European banking markets are still organised primarily along national lines with relatively little cross-border penetration in the major economies. Securitisation transactions facilitate funding and investment flows between European banks and hence are a significant source of integration. Even when the current funding problems of European banks are resolved, there would be efficiency gains within European banking from the greater integration that securitisation permits.

Question 2. Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?

We broadly agree with the characterisation of impediments to the revival of the market but we would place greater emphasis on the regulatory background. The framework that is currently emerging appears excessively conservative, uncoordinated across regulatory bodies and still full of uncertainties as far as investors and originators are concerned.

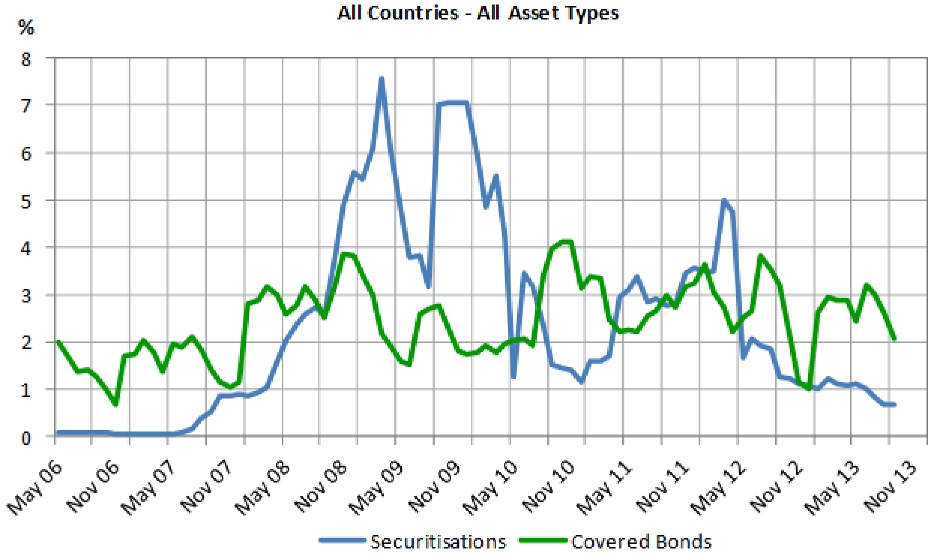
There is a perception in the industry, which we share, that the Basel regulations have been designed for the US market which was at the root of the crisis and that they are inappropriate for the European market that is different in structure.

We believe that regulators have paid insufficient attention to comparability across (i) risk exposures and (ii) financial institutions. On comparability of exposures, the discipline of maintaining approximate capital neutrality between all the tranches in a securitisation and the underlying pool (which guided the Basel II calibration of securitisation capital) has been abandoned.

Some deviation from neutrality may be justified to reflect model risk, agency risk and other issues. The degree of non-neutrality in current proposals is implausibly great for many basically sound asset classes and has been included in an arbitrary way by adding to capital a conservative measure of multi-period expected losses that has little to do with agency or model risk.

Again on the comparability of exposures, covered bonds and securitisations are treated in radically different ways under proposed Solvency II, Basel capital and Liquidity Coverage ratio rules. We showed in Perraudin (2014a) that the liquidity of securitisations (as measured by bid-ask spreads) has been lower than but not completely different from that of covered bonds. Some subsectors of the securitisation market, such as auto loans, have liquidity similar to that of covered bonds. Perraudin (2014b) shows that high quality European securitisation tranches actually exhibited lower volatility in the period since the crisis than similarly rated covered bonds (see Figure 1).

Figure 1: Average Volatilities for Covered Bonds and HQS Securities Over Time



On comparability of financial institutions, the current Basel capital proposals include a hierarchy that will lead the External Ratings Based Approach (ERBA) to be predominant in Europe and proxy based applications of the Internal Ratings Based Approach (IRBA) to be predominant in the US. These proposals therefore imply a completely bipolar and inconsistent set of capital charges internationally. (Our own private QIS-style calculations suggest they are quite inconsistent.)

Question 3. Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised

above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?

The main impediment for originators (as for investors) is the current wave of excessively conservative regulation. See the response to Question 3 for more detail.

Table 1: Capital Premiums Implied by Duponcheele et al (2014b) Calibration by Sector

	Securitisation Regulatory Asset Class	$CSSF_M$	
		Senior	Non-Senior
Wholesale	Granular Short Term Bank/Corporate	1.00	1.05
	Granular Low RW Medium to Long Term Bank/Corporate	1.05	1.18
	Granular High RW Medium to Long Term Bank/Corporate	1.10	1.36
	Granular Small- and Medium-sized Entities	1.05	1.17
	Specialised Lending (Commodities Finance)	1.00	1.18
	Specialised Lending (Project Finance)	1.10	1.33
	Specialised Lending (Object Finance)	1.16	1.52
	Specialised Lending (Income Producing Real Estate)	1.06	1.19
	Specialised Lending (High Volatility Commercial Real Estate)	1.08	1.24
	Other Granular Wholesale	1.07	1.23
	Other Non-Granular Wholesale	1.08	1.26
Retail	Low RW Residential Mortgages	1.14	1.47
	High RW Residential Mortgages	1.22	1.73
	Revolving Qualifying Retail	1.06	1.39
	Other Retail	1.10	1.35

Table 2: Capital Premiums Implied by Duponcheele et al (2014c) Calibration by Sector

	Securitisation Regulatory Asset Class	Senior	Non-Senior
		p	***p***
Wholesale	Granular Short Term Bank/Corporate	0.27	0.29
	Granular Low RW Medium to Long Term Bank/Corporate	0.47	0.54
	Granular High RW Medium to Long Term Bank/Corporate	0.36	0.52
	Granular Small- and Medium-sized Entities	0.43	0.49
	Specialised Lending (Commodities Finance)	0.21	0.28
	Specialised Lending (Project Finance)	0.55	0.69
	Specialised Lending (Object Finance)	0.5	0.77
	Specialised Lending (Income Producing Real Estate)	0.55	0.62
	Specialised Lending (High Volatility Commercial Real Estate)	0.52	0.62
	Other Granular Wholesale	0.54	0.62
	Other Non-Granular Wholesale	0.58	0.67
Retail	Low RW Residential Mortgages	0.44	0.66
	High RW Residential Mortgages	0.44	0.89
	Revolving Qualifying Retail	0.23	0.41
	Other Retail	0.46	0.61

In Duponcheele et al (2014b) and (2014c), we have performed detailed calibrations of the Basel proposals (see BCBS (2013)). The Standardised Approach under the proposals implies a capital surcharge over and above the on-balance-sheet capital a bank must hold against the loan pool of 100%. Our analysis shows that this is perhaps appropriate for non-senior tranches of subprime deals but is too conservative for other asset classes. For short dated real economy securitisations like trade receivables the premium should be 5% for a non-senior tranche for example. See Table 1. Note that the figures in Table 1 are capital multipliers so one must subtract 1 and express in percent to obtain a figure comparable to the 100% capital add on implied by the SA capital formula of BCBS (2013).

Table 2 shows the results of the calibration when they are mapped into the Simplified Supervisory Formula Approach (SSFA) used in the Basel proposals (see BCBS (2013)). The results may again be compared with the capital add on of 100% assumed in the SA. The add-on varies from 23% for Revolving Retail senior tranches to 89% for subprime mortgage backed deals.

Question 4. Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

Market liquidity is clearly an issue for investors in securitisations such as insurers or banks. Even investors less obviously subject to concerns about liquidity like pension funds typically care about possible costs they may experience in liquidating positions. The conservative treatment of securitisations under current regulatory proposals on the LCR is unhelpful in this regard as it discourages banks from holding securitisation positions in trading books.

Question 5. The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

As mentioned above, we are part way through writing a research paper on what should constitute a qualifying security. The comments below are extracted from that paper.

A satisfactory definition must be based on a set of principles and cannot be reduced to a single sentence. The suggested definition ("a security where risk and pay-offs can be consistently and predictably understood") describes necessary characteristics of a qualifying securitisation. It does not constitute a fully satisfactory definition, however. For example, few would suggest that securitisations of equity positions would be eligible even though there is substantial statistical evidence on the distribution of equity returns that could be used to analyse them.

The "principles" included in Box 3 appear to us more like criteria than principles. We would suggest that criteria be deduced from general considerations of what is to be achieved with the qualifying securitisation label.

We suggest as principles:

a) **Sustainability Principle**
The underlying assets should be sustainable and the securitisation market for such underlying assets should be sustainable.

b) **Safe Securitisation Principle**
The underlying assets should have a history of low credit risk through time, the structure should be of low legal risk. In addition for qualifying securitisation, the tranche must be sufficiently safe.

c) **Transparency Principle**

The underlying assets and the structure should be disclosed in a transparent manner to facilitate the risk assessment and comparisons. The ‘substance over form’ principle is a form of application of the transparency principle.

d) **Simplicity Principle**
The nature of repayment risks for the underlying assets should be simple, and the structure should be designed in a simple manner.

e) **Regulatory Governance Principle**
Control parameters should permit regulators to achieve their objectives and exercise judgments in assigning the qualifying securitisation label across types of exposure.

f) **Objective Statistical Basis Principle**
Any risk measure used in a qualifying securitisation definition (e.g. a rating or a formula-based risk measure) should be based on a clear, objective statistical measure of risk.

Of these, the principle that requires the most comment is the **Sustainability Principle**. In our view, qualifying securitisations should exhibit the characteristics that both pool assets and the securitisations deals themselves come from stable, predictable markets that will continue to operate over time and at different stages of the economic cycle.

Markets that do not have these characteristics are less likely to offer stable, reliable historical loss experience and to exhibit superior risk and liquidity outcomes. In effect, they will be subject to regime changes in which the underlying economic activity represented by the creation of assets or the structuring activity involving those assets becomes uneconomic from time to time. Conceivably the fluctuations in activity could occur without investors suffering losses but markets subject to regime changes are always likely to be more complex to analyse and collapses in activity levels are also likely to be associated with sharp declines in liquidity.

To illustrate **asset sustainability**:

A residential mortgage for an owner-occupier is sustainable. A with-recourse residential mortgage for a buy-to-let property is sustainable. A credit card is sustainable. An auto loan or an auto lease to purchase or lease an automobile is sustainable. A corporate trade receivable is sustainable. A corporate loan whose purpose is to finance an investment is sustainable (typically, SME loan, non-leveraged corporate loan).

A corporate loan whose purpose is to refinance existing debt is sustainable if the debt is arriving at maturity (typically, Real Estate loans) but is not sustainable if the refinancing is done as an early repayment based on market conditions (typically, Leveraged Loans) - demand for the asset will stop when spreads widen. A corporate loan whose purpose is to distribute exceptional dividends is not sustainable (typically, Leveraged Loans). Demand will stop during down cycle as lenders are not sure whether it is the right time to weaken the company. A hedge fund investment is not sustainable.

To illustrate **market sustainability**:

For the securitisation market to be sustainable, the underlying assets should be illiquid and not marketable individually on the capital markets. The securitisation will provide the ‘primary’ funding source on the capital markets.

If an individual bond or ABS or tradable loan is individually marketable on the capital markets, those instruments can already get their primary funding from capital markets investors. A securitisation of such underlying instruments often becomes 'an arbitrage transaction' the main aim of which is to extract margins, not to provide funding for the underlyings. The funding provided to the underlyings is a side effect of the transaction. The securitisation market will stop completely the moment the margin extraction cannot occur at a profit.

According to the sustainability principle, the securitisation market for 'CDOs of ABS' is not sustainable, as the underlying ABS are already liquid and tradable on the capital markets. 'Arbitrage' securitisations can provide low risk senior tranches (e.g. CLOs of Leveraged Loans), while neither the underlying assets nor the securitisation market are sustainable. Balance-sheet Corporate Securitisations are sustainable, as both the underlying assets are sustainable and the securitisation market is sustainable. A typical example would be SME loans: those are illiquid assets and the securitisation provides the primary 'funding' source on the capital markets.

An individual auto loan or auto lease, credit card or residential mortgage is not individually marketable on the capital markets, therefore those instruments, when pooled, will access their funding on the capital markets on a 'primary basis'. The securitisation market is sustainable (when combined with other sustainability constraints, such as responsible lending).

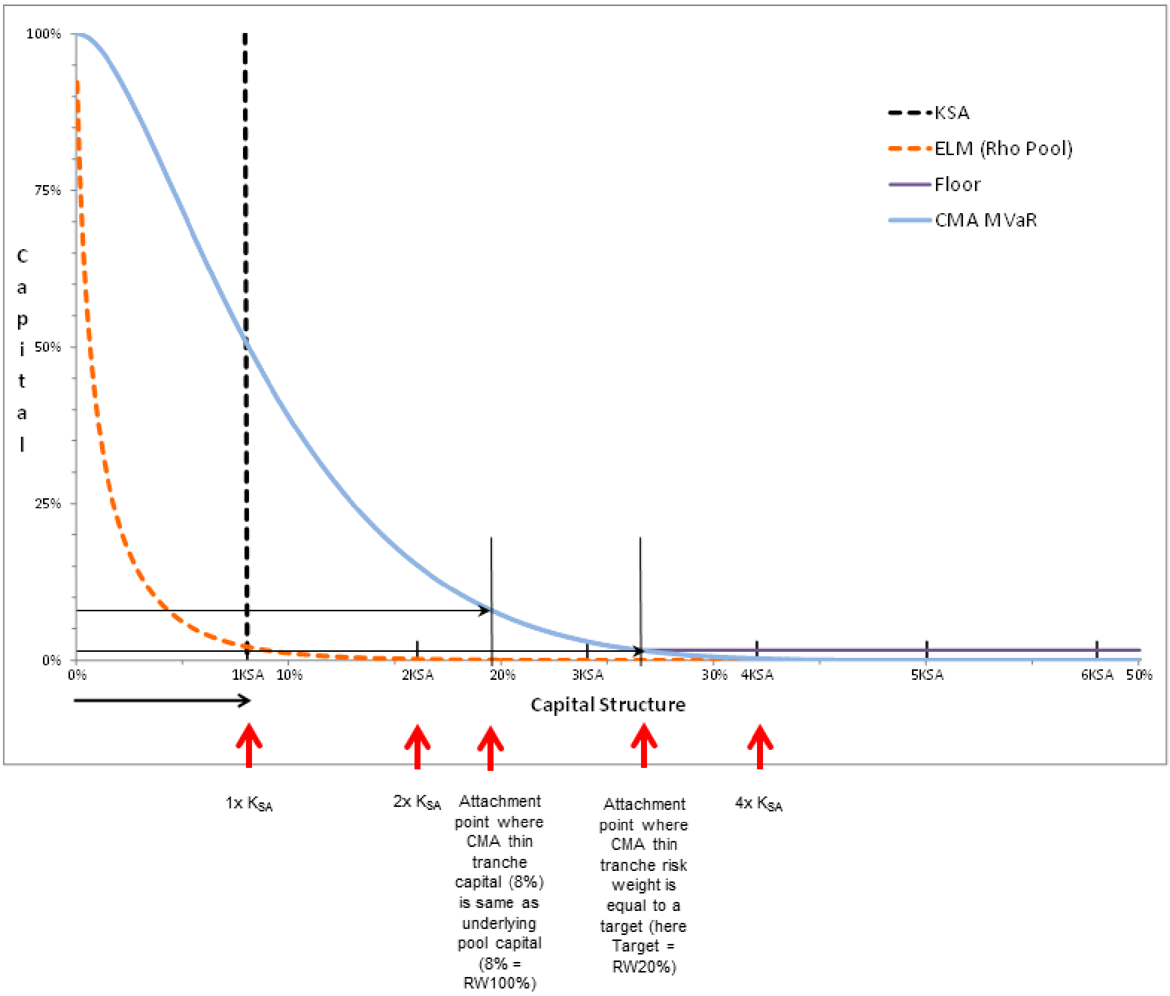
Synthetic transactions done by banks' portfolio managers often refer to underlying loans already present on the balance sheet. Those securitisations are sustainable. Tranches on benchmark indices might be very simple synthetic transactions, with very safe senior tranches, but they are not sustainable. There is a disconnect between the index composition and the balance sheet of the bank; there is the capacity to multiply the risk of the underlying assets many times. Classic examples are transactions done on CMBX or Itraxx.

We have some detailed comments on the criteria set out in Box 3. These are as follows:

- Qualifying securitisations should have simple sequential payment built into their structures. For example, exotic structures such as "Y" and "H"-structures are not simple. Other departures from simple payment structures should be ineligible.
- Qualifying securitisations should be limited to senior tranches when used in the context of liquidity criteria. We do not think that "most senior" should be a criterion in determining qualifying securitisations for capital purposes. Regulatory capital formulae and look-up tables already distinguish between most senior tranches and others. So to the extent that a qualifying securitisations label is used to justify preferential capital treatment, it is not necessary to include them in the definition. There is also a danger that, because the attachment of senior tranches is largely determined by ratings agency criteria, the qualifying securitisation label come to reflect these criteria as a consequence of requiring that a security be a most senior tranche.
- We do not believe that it is sensible to include the requirement that the securities be rated by up to two credit rating agencies. This flies against the general policy objective of reducing regulatory reliance on agency ratings. See the response to Question 13 below.
- On the other hand, we think that there is a need to verify that the attachment point of a securitisation is sufficiently conservative. Rather than relying on ratings, we propose in Duponcheele et al (2014a) how this might be achieved using the Conservative Monotone Approach (CMA), a simple, closed-form risk formula consistent with and largely derived from the Basel II capital formulae. Figure 2 illustrates how assessing that an attachment

point is sufficiently conservative may be achieved using a simple analytical formula (rather than an agency rating). The blue line in the figure shows the Marginal VaR for thin tranches based on the CMA. One may read off from this curve, for example, the tranche attachment point that implies tranche risk no greater than that of the underlying pool assets. For 8% risk weights assets, this is shown in the picture to imply an attachment point in excess of 20%.

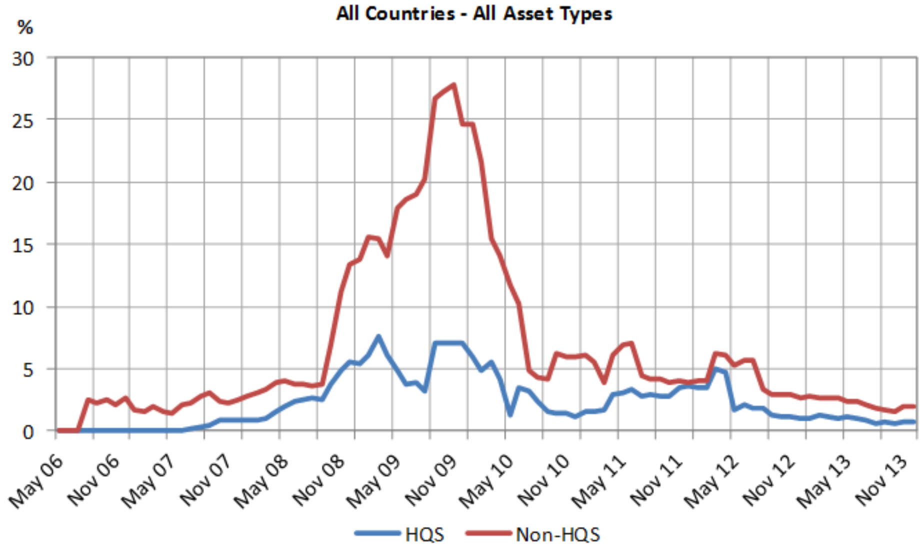
Figure 2: Deciding Whether a Tranche Attachment Point is Sufficiently Conservative



Question 6. Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?

As Perraudin (2014b) demonstrates, holding ratings constant, securitisations satisfying simple High Quality Securitisation-type criteria are distinctly more liquid (as measured by the average bid-ask spread) than those that do not (see Figure 3). Labelling exposures explicitly as qualifying securitisations could encourage investor interest and this would be stimulated much more and liquidity enhanced if concessions in LCR eligibility were accorded to this category of securities. Hence, the qualifying securitisation label, if suitable linked to regulatory rules, could definitely reinforce a liquid market.

Figure 3: Average Volatilities for HQS and Non-HQS Securities Over Time



Question 7. These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?

Certifying eligibility of 'qualifying securitisation' status should be a matter of verifying that a securitisation possesses certain observable characteristics. It should not involve exercise of judgment.

We believe that certification should be performed by a non-for-profit organisation like Prime Collateralised Securities or True Sale International used to operating a relatively "light", factual assessment. It would be inappropriate to rely on ratings agencies or similar entities that are (i) profit making and (ii) actively engaged in management of their reputations through exercise of more or less tough judgments.

Regulators may prefer to be actively involved in the process. We believe that the certification process will be more effective if it involves the industry and so would suggest that official control could be managed by having regulatory body representation on the board of a not for profit agency that also includes industry representation.

Question 8. Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?

Central bank repositories of loan level data within Europe offer copious but somewhat undigested and hard to use datasets. An effort should be made to provide better interfaces and to accompany basic data with studies and publications that present summaries and monitoring investigations of the state of loan markets. This would undoubtedly assist financial regulators and those responsible for financial stability but it would also encourage use of the data and guide the data repositories in how to make data more accessible and convenient for users.

Question 9. Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?

Greater standardisation of prospectuses, improvements in trade transparency and centralised storage of prospectuses are all welcome developments and will bring long run benefits to the market in improving scope for risk analysis by investors. They will not play a major role in the determining whether the market revives, however, which depends more on the regulatory framework and developments in the bank funding market.

Question 10. Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?

In principle yes, better access to credit data will enhance investors' ability to assess risk and hence develop the market. However, this is not the major obstacle the market faces which remains the overhang of regulation that is highly non-neutral vis-a-vis loans, encouraging banks to keep loans on small balance sheets and look for funding other than through securitisation.

Question 11. In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

It is not clear what is meant by macro-economic data. Industry level data would be very helpful for understanding the state of different loan markets and assessing relative performance. It is impractical to suppose this can be generated by individual banks operating on their own data. It would be better if a regulatory agency collected default data at an individual loan level and prepared standardised loan loss information for different markets.

Some countries such as Spain and Italy attempt this and their central banks publish loan loss data for fairly coarse sectors but a more systematic European level effort would be valuable, especially if the data should be broken down in more useful ways by vintage, sector etc.

Question 12. Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

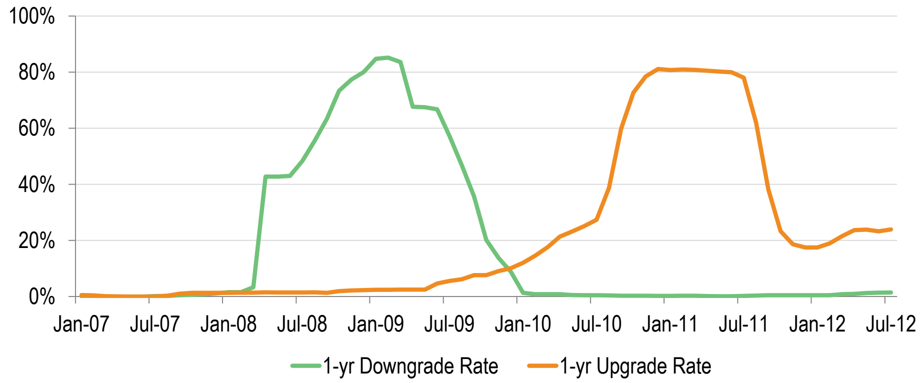
Benchmark indices generated by the industry are not the solution. It would be better for central banks to collect data on loan losses from banks in a standardised form, comparing it with performance data from securitisation pools and then publishing the results. Such an activity would have big benefits in financial surveillance. It would be preferable to base the activity within central bank, because it is important that analysis be performed to good academic standards.

Question 13. Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

We think that the problems around securitisation ratings are more pervasive and deep-seated than this question suggests. Obliging the agencies to provide ratings that strip out the effects of sovereign ceilings is a limited and partial fix to one aspect of these problems.

We have written a paper describing the problems created for bank capital management since the crisis of the volatility and non-transparency in securitisation ratings (see Duponcheele et al (2014a)). Struggling to re-establish their reputations, the ratings agencies made managerial rather than analysis-based decisions in the aftermath of the crisis leading to wholesale downgrades in some asset classes.

Figure 4: The Impact on CLO Ratings of the Moody's 2008 Stress



An illustration of what occurred is the stress that Moody's imposed on CLO pool default rates which was quietly removed without fanfare eighteen months later. This led to a wave of downgrades followed by a wave up upgrades. Figure 4 (taken from Duponcheele et al (2014a)) shows the effects. The consequence was a highly procyclical boost to regulatory capital for banks' CLO positions in Europe that was not, as far as we understand, the result of new data or analysis about actual risks.

We believe that the authorities should be more vigorous in reducing the reliance on securitisation ratings particularly in regulatory applications. In May 2013 the European Parliament and Council adopted regulation on credit rating agencies which included reduction of reliance on credit ratings as a stated aim. Yet, many current regulatory initiatives have the effect of further entrenching credit ratings. As we argue in Duponcheele et al (2014a), the alternative to ratings is a formula-based approach like that of the Conservative Monotone Approach (CMA) exposited in Duponcheele et al (2014b).

Question 14. How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

We do not think this requires regulatory intervention except possibly to include in the criteria for qualifying securitisations steps to mitigate counter-party risk in securitisation transactions.

Question 15. With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?

Recognising the superior risk and liquidity performance of such securities (see Perraudin (2014b) which documents the disparity in the performance of securitisations possessing simple observable characteristics) through capital and liquidity rules is an appropriate policy option.

Specifically, the BCBS (2013) proposals impose a 15% floor on risk weights. The floor for Covered Bonds under the SA is 10%. Perraudin (2014) shows that HQS return volatility is actually less than that of Covered Bonds suggesting that the floor for securitisations might be lowered for a qualifying category of securitisation.

It is also striking that, under the currently proposals, the floor is binding for a large part of the market. We have performed capital calculations for a sample of 921 European securitisation tranches. We find that the floor binds for 64% of senior tranches when we employ the SA. One could reasonably expect the percentage to be higher when one employs the IRBA with proxy data. This outcome is surely not what is intended as it means that almost all risk sensitivity has been removed from the framework for senior tranches.

The BCBS proposals propose an IRBA approach that will be inaccessible to European banks unless there is a substantial relaxation in current rules on calculating IRBA pool capital, K(IRBA) Unless the current proposals are altered, the ERBA is, therefore, likely to be the dominant set of capital rules for European banks. The ERBA lookup table should be recalibrated to allow for an HQS distinction

Ideally, there would be changes in the BCBS proposals. These would include (i) a reduction in the conservatism of the calibration with differentiation between asset classes in the capital premiums adopted and (ii) changes in the hierarchy of approaches with a more risk sensitive, asset class specific Standardised Approach being above the current External Ratings Based Approach (ERBA).[1] But if a change in the hierarchy is not implemented, there is little point in introducing HQS distinctions in the capital framework except for the floor and the ERBA.

Question 16. Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

The other policy initiatives discussed by the consultative paper involving improvements in transparency, data availability etc are undoubtedly worth considering. But substantial efforts have already been made in this regard by the industry and by regulators including energetic efforts by the very same two central banks that have issued the discussion paper. So, while further efforts in this direction are welcome, we do not believe they will transform the prospects for the European securitisation which remain bleak.

[1] Only through a change in the hierarchy will we avoid the situation in which US and European banks rely on broadly inconsistent approaches to calculating capital, the IRBA and ERBA respectively. (This regrettable outcome might also be avoided if there were major changes in the approach taken to calculating K(IRBA) in Europe but this appears unlikely as it would be inconsistent with CRDIV as it currently stands.)

The market will only be revived if regulators reassess the current direction of regulation. The changes in regulation may be justified for securitisations of non-recourse, sub-prime mortgage markets issued under an originate to distribute business model but they are excessively conservative when applied to vertically integrated securitisations issued for funding purposes by effectively regulated European banks. Regulators' willingness to drop the basic principle of neutrality or comparability for securitised exposures[2] makes much of the market uneconomic under the proposed regulatory framework driving activity towards covered bonds, shadow banking or more deleveraging.

The notion of qualifying securitisations could be helpful in this regard if it allows distinctions to be made in regulations between "safe" and "less safe" securitisations on the one hand and "liquid" and "less liquid" securitisations on the other.

Question 17. Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?

The costs of shortfalls in lending that revival of the securitisation market might reduce could alternatively be reduced by widespread use of covered bonds as a source of funding or by the substitution of bank loans with lending by shadow banks. Neither alternative is attractive. Excessive use of covered bonds leads to encumbered bank balance sheets to the detriment of unsecured banking activities and increasing losses to deposit guarantee schemes in the event of a bank failure. Greater use of shadow banking reduces the transparency of loan markets and raises the spectre of unpredictable future crises.

Question 18. Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?

As mentioned in the response to Question 5, the Box 3 "principles" (which we view as criteria rather than principles) seem reasonably sensible as a basis for qualifying securitisations.

But we believe one should be clearer about the objectives one may have in devising a qualifying securitisation label. The issue is not just whether an asset is "amenable to risk assessment," but rather whether it is likely to exhibit better risk and liquidity performance than securities that are treated as equivalent in current or proposed regulatory frameworks. This would be required to justify differential treatment of qualifying and non-qualifying securities in regulatory frameworks.

Empirical evidence in this regard is provided by Perraudin (2014b) which documents the fact that, holding ratings constant, a category of High Quality Securitisations (HQS) defined on the basis of simple observable features exhibits very markedly lower risk as measured by volatility (see Figure 3 above) and higher liquidity (as measured by narrow bid-ask spreads) than non HQS.

[2] Dropping neutrality would certainly be justified if there were significant indications of agency costs but this is not the case at least for the European market.

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July 4, 2014

Dear Sirs

Standard & Poor's Comments On Bank Of England And European Central Bank Securitization Discussion Paper

Standard & Poor's Ratings Services ("S&P") appreciates the opportunity to comment on the Bank of England's and European Central Bank's discussion paper regarding the European securitization market, dated May 29, 2014. We agree with the authors that there are several potential benefits of a well-functioning securitization market but note that aggregate volumes of investor-placed European securitization issuance are significantly down on the levels seen before the financial crisis. In our view, the wider macroeconomic and banking system backdrop has held back issuance in recent years, more than any specific securitization industry issues. Looking ahead, however, we believe that current regulatory proposals pose a significant threat to the viability of the European securitization market. A common definition for "qualifying securitizations"—and an acknowledgment in regulations that such simple, transparent structures have generally performed well—could help to revive the market, in our view.

Our more detailed responses to the discussion paper are set out in the Appendix below.

We would be pleased to discuss any of the matters we have raised with you further. If you have any questions or require additional information, please contact Michelle Weston (michelle.weston@standardandpoors.com, +44 20 7176 3646) or Andrew South (andrew.south@standardandpoors.com, +44 20 7176 3712).

Yours faithfully

Michelle Weston
Standard & Poor's Ratings Services

STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

Appendix

Below we provide our more detailed comments on the topics raised in the discussion paper.

A Well-Functioning Securitization Market Has Several Potential Benefits

The discussion paper sets out four uses of securitization and highlights their potential benefits to issuers, investors, and the financial system as a whole:

- An investment instrument for nonbanks and banks;
- A funding tool to support real economy lending by banks and nonbanks;
- A risk transfer device for bank originators; and
- A means of generating high quality collateral to meet increased demand.

We agree that—in a well-functioning market—all these applications of securitization could bring potential benefits, and we are pleased that the discussion paper adopts such a comprehensive view.

In our opinion, policymakers' recent public statements on securitization have varied in emphasis and ambition. Some seem focused on rebuilding the European securitization market in its existing image, i.e., as mostly a wholesale funding tool for bank originators. Others appear more ambitious, in our view, for example contemplating wider use of securitization to underpin a shift toward greater capital market, nonbank funding for real economy borrowers, such as small and midsize enterprises.

We believe that it is important to view securitization as a technology that may be applied in a variety of circumstances to achieve different aims, and to distinguish between these different uses when assessing the current state of the market and when considering future policy options.

Used as a funding tool to support bank lending, a key benefit of securitization may be to diversify the originators' investor base, potentially promoting banking system stability. More diverse funding sources could also, in principle, lead to lower overall funding costs for lenders—a saving which they may partly pass on to underlying borrowers. However, we note that the increasing regulatory burden and ancillary costs associated with issuing securitizations—compared with other types of funding (e.g., covered bonds)—may ultimately make securitization relatively uncompetitive for bank originators from a cost perspective.

However, further prospective benefits of a revived European securitization market could derive from its potential role as a form of bank disintermediation. Given ongoing pressures in the European banking system, we have seen significant bank balance sheet retrenchment and a trend toward greater direct capital market funding of the real economy. We expect U.K. and eurozone non-financial corporates to seek $1.5 trillion in new bond and other debt security issuance over the five years to 2018, to finance growth (see "Credit Shift: Standard & Poor's Expects $6.6 Trillion In New Corporate Bond Issuance Over The Next Five Years," published on June 15, 2014). The question is whether securitization could also play a part in this disintermediation trend, for example by helping fund nonbank lending to smaller corporates and consumers who cannot tap debt capital markets directly.

To achieve these benefits would require a greater emphasis on securitization by nonbank originators and/or on bank securitizations in which a significant portion of the economic risk is transferred to end investors.

We note that sectors dominated by nonbank originators are currently among the healthiest in the European securitization landscape. For example, in 2013, non-deposit-taking originators placed about €10 billion of auto loan and lease-backed securitizations with investors, exceeding typical pre-crisis annual volumes in the sector. Similarly, the leveraged loan collateralized loan obligation (CLO) asset class has grown strongly since early 2013—another example of securitization technology supporting lending that is effectively outside the banking system. We expect that, as a funding tool, securitization could in the long term become more significant for nonbank originators and sponsors, who may have more limited access to funding alternatives than their bank counterparts.

Banks' use of securitization to transfer a significant portion of the economic risk of the underlying assets has been limited in recent years. This may be partly because post-crisis accounting and regulatory rules make it more difficult to de-recognize securitized assets from originators' balance sheets and to achieve regulatory capital relief. Indeed, other regulations introduced since the financial crisis effectively encourage securitization originators to retain a portion of the underlying assets' risk, in order to counter the possibility of adverse portfolio selection.

For many types of real economy lending, banks will likely always remain the principle originators of credit, given their infrastructure and borrower relationships. In order for securitization to act as a viable, large-scale means for bank originators to subsequently sell on the assets they have originated to capital market investors, regulatory capital relief and risk retention rules may therefore have to evolve.

Pending Regulatory Changes Are The Greatest Impediment For Investors

In our view, pending changes in the regulatory treatment of securitization exposures are the greatest structural threat to the future of the European securitization market, as they could potentially switch off demand from much of the investor base. In particular, a number of proposed changes to banks' and insurers' regulatory capital and liquidity requirements treat securitizations rather conservatively, in our view, relative to their observed performance and relative to some other credit asset classes, such as covered bonds and whole loan portfolios.

For example, in proposed revisions to the Basel securitization framework for bank capital charges, the risk weight for typical 'AAA' rated securitization exposures under some calculation approaches is up to eight times higher than under current regulations (see "Proposed Revisions To The Basel Framework Could Deter Banks From Investing In European Securitizations," published on April 3, 2014). Under the latest public draft calibration of Solvency II—a regulation for European insurers—the proposed capital charges for certain securitization investments remain very high compared with some other fixed income instruments. For example, some 'AAA' rated securitization tranches would attract charges that are more than 17 times higher than a similarly-rated covered bond. Counterintuitively, an insurer holding a 'AAA' rated commercial mortgage-backed security could require more than four times as much capital as another insurer holding the unenhanced portfolio of mortgage loans backing that security (see "EIOPA's Revised Solvency II Calibration Still Risks Turning European Insurers Away From Securitizations," published on March 19, 2014). This could deter banks and insurers from holding securitizations.

Many of the other investor impediments mooted in the discussion paper are not new to the European securitization landscape since the financial crisis, and have instead always been features of the asset class. As such, they are unlikely to directly explain why issuance in some areas of European securitization has not returned to pre-crisis volumes.

For example, the pass-through nature of many securitizations may mean that investors have less certainty over cash flows than they do with bullet bonds—so-called prepayment risk—but passthrough structures have always been prevalent in the securitization market and are therefore arguably not a key reason why issuance hasn't returned in greater volumes. As another example, transparency and standardization of transaction documentation and investor reporting have likely increased since the crisis, but remaining idiosyncrasies are not new.

That said, such features of the European securitization market may be worth considering if it is to attract a new, broader investor base than before. In this context, other factors may also be important. For example, one of the key historical differences between the European and the more mature U.S. securitization markets, in our view, has been the degree to which the securities are included in fixed income indices, which investors use to benchmark performance and define fund mandates.

In general, however, we believe that the most significant impediment to greater investor engagement in the European securitization market is the uncertainty caused by pending regulatory changes. Many of the other market impediments may be cyclical, in our view, and mostly affect originators rather than investors, as detailed below.

Originators Currently Have Little Funding Need And Many Alternatives

Rather than centering on investor demand, we expect that many of the factors depressing European securitization issuance in recent years have been on the supply side. In particular, low securitization issuance in some areas may simply reflect low volumes of underlying loan originations.

For example, the two largest markets for residential mortgage-backed securities (RMBS)—the U.K. and The Netherlands—have not returned to pre-crisis volumes. However, viewed in the context of sharply lower underlying mortgage lending, RMBS volumes in recent years do not appear unhealthy. For example, Dutch RMBS issuance of about €15 billion in 2013 may have been down by 50% on the volume in 2006, but gross mortgage lending in The Netherlands was also down—by more than 55%—over the same period. Therefore, relative to underlying lending activity, we could view Dutch RMBS issuance as continuing at a reasonable level.

Many European banks that previously originated securitizations have been retrenching for some years, shrinking their balance sheets as part of a strategy to raise capital ratios, and thereby also reducing their need for new wholesale funding issuance. What new funding they have raised has included a large slug of borrowing from cheap, subsidized official sector programs, such as the European Central Bank's (ECB) three-year long-term refinancing operations (LTROs) and the Bank of England's Funding for Lending Scheme. While positive in many ways, these schemes may have effectively cannibalized new issuance volumes for many types of capital market debt funding, including securitization, but also senior unsecured and covered bonds. This has likely been especially true in the two major pre-crisis markets where investor-placed securitization has yet to re-emerge in earnest—namely Italy and Spain—and where the banking systems remain large users of the ECB's LTROs.

While most post-crisis regulatory initiatives present challenges to investors, in some areas they have also affected issuers. For example, risk retention rules may not have caused undue difficulties for large bank originators, who often use securitization as a relatively small part of their overall funding strategy and therefore have few problems complying. However, when applied to collateral managers in leveraged loan CLOs, for example, the rules have presented a greater burden, as few managers have the balance sheet capacity to retain significant portions of the CLOs that they oversee.

In the case of the leveraged loan CLO market, therefore, the retention rules could risk undermining an otherwise well-functioning channel for allowing corporates indirect access to capital market funding—complementing the bank credit channel—because they are not particularly tailored to the specifics of the asset class. While risk retention may be an uncontroversial means of aligning originator and investor interests in bank-originated RMBS, for example, CLO managers' economic interests could be aligned with those of CLO investors in other ways—such as through management fee structures—rather than through retention of a significant balance sheet position in the transaction.

The aim of retention rules is clearly to address concerns over misalignment of interests between originators and investors. However, they likely narrow the range of situations in which originators can significantly transfer economic risk through a securitization and achieve regulatory capital relief. At the same time, regulators and other official sector entities have sought to reduce information asymmetry between originators and investors through enhanced disclosure requirements. In future, it may be beneficial to make rules regarding these considerations more nuanced and integrated, to allow for more diverse use of securitization technology while maintaining safeguards for investors and financial stability. For example, if investor and originator interests are aligned because the originator has retained a portion of the securitization, then disclosure requirements on the underlying collateral arguably need not be as high. By contrast, if a lender securitizes and sells on substantially all of the economic risk in a portfolio of loans that it has originated (with no risk retention), then it could be held to a higher disclosure standard regarding the underlying loans, given that its post-securitization economic interest is lower.

Current Rating Methodologies Shouldn't Significantly Constrain Issuance

The discussion paper also argues that one of the impediments facing the European securitization market may be a reliance on credit rating agencies. In particular, the paper mentions that "rating agencies now require far greater levels of credit enhancement to achieve a given rating" on a securitization tranche than they would have done some years ago—and that this makes securitizations "more costly to issue". The paper also refers to the fact that—in some European countries—rating agencies currently limit the highest rating that they will assign to a securitization tranche, with this "rating cap" derived from the rating on the respective sovereign, but "not related to the underlying collateral quality". As a result, 'AAA' ratings are generally not currently achievable in securitizations backed by underlying collateral from Italy or Spain, for example, regardless of a tranche's credit enhancement or the underlying collateral quality. The paper implies that this could be problematic, given that 'AAA' ratings were historically the "benchmark" in the securitization market.

Given that our ratings on securitization tranches represent an opinion regarding the tranches' creditworthiness, we believe that their general decline over recent years is a justified and necessary reflection of the riskier economic environment, as well as some lessons from the crisis, which may have caused us—and other market participants—to reassess certain risks. We would, however, contest the idea that a shift toward lower ratings should necessarily constrain securitization issuance.

"Requir[ing]…greater levels of credit enhancement to achieve a given rating" is equivalent to assigning a lower rating for a given level of credit enhancement. In other words, for a given securitization tranche, the rating today may be lower than it was some years ago. We note that this situation is no different to many other classes of credit instrument. Indeed, of our European securitization ratings that were outstanding in mid-2007, we had lowered about 55% (by number) by the end of 2013. This is little different to European financial institutions, where we lowered 65% of our ratings over the same period, or European nonfinancial corporates, where we lowered 50%. The equivalent figure for global sovereigns was 45%.

This simply suggests that our opinion of debtors' creditworthiness across a wide variety of sectors has generally fallen over the past six to seven years, or, equivalently, that credit risk has generally increased, in our assessment. This is perhaps unsurprising, given ongoing depressed economic conditions and dysfunctional banking systems across large parts of Europe.

However, we question whether the decline in securitization ratings has materially reduced originators' incentives to use securitization relative to other capital market funding sources. Even though the all-in risk premium that originators have to pay for securitization funding may have risen since the pre-crisis period—given higher credit enhancement requirements and higher credit spreads—the risk premia on originators' other funding options have risen too. This is in line with a general repricing of risk to levels that are arguably more realistic than was evident before the financial crisis began in 2007. In that sense, the rising cost of securitization funding may not result in a relative disincentive for originators to use it. In fact, since 2010—a period during which we have generally raised our credit enhancement requirements—we estimate that securitization's share in the mix of European banks' investor-placed wholesale funding issuance has remained fairly steady.

Finally, we consider the specific point regarding sovereign-related rating caps, and question whether the current inability to achieve 'AAA' ratings in some countries should necessarily be a significant factor holding back issuance.

We have long considered country risk as an important factor in our ratings, including those on securitizations (see, for example, "Weighing Country Risk In Our Criteria For Asset-Backed Securities," published on April 11, 2006, and previously "Assessing Sovereign Risk In Structured Finance In Emerging Markets," published on June 15, 1998). In practice, for long periods when country risk in most European markets was low, this consideration didn't generally constrain our securitization ratings. However, as country risk has risen in some areas over recent years, this situation changed. An early example of country risk considerations coming to the fore was when we lowered some of our ratings on senior tranches in Greek securitizations on Feb. 19, 2010 (see "'AAA' Ratings Lowered In Greek Structured Finance Transactions Following Reassessment Of Country Risk").

When we lower any of our ratings—whether on a corporate, a bank, or a securitization tranche—as a consequence of a related sovereign downgrade, it is because we believe the creditworthiness of the instrument or entity in question has decreased due to higher country risk. In such cases, we believe a downgrade properly reflects the increased likelihood of certain "tail events" for debtors in that country. For example, the risk of a deposit freeze, capital controls, or a disorderly exit from a monetary union and devaluation of any new currency. In other words, we do not agree with the assertion in the discussion paper that securitization tranches whose ratings are capped by country risk considerations are "more harshly treated than their likely credit performance would imply". On the contrary, elevated country risk may directly imply an elevated risk of poor credit performance.

We also disagree with the paper's assertion that "rating caps reduce the information content of the rating itself, such that an investor cannot easily distinguish between…a true single-A rated bond and a rating-capped single-A bond". In our view, it is erroneous to imply that the rating on one bond in this example is a "true" single-A rating, while the other is in some way artificial. Rather, if we rate two bonds 'A', it is because they have similar creditworthiness, in our opinion. Of course, it may often be the case that we view the creditworthiness of one bond as being constrained by different factors than the creditworthiness of another similarly-rated bond. For example, one RMBS tranche may be rated 'A' because there are a number of high loan-to-value ratio mortgage loans in the underlying pool, another due to a high proportion of self-certified borrowers, another due to counterparty risk considerations, and another due to country risk.

The fact that 'AAA' ratings are generally not currently achievable on securitization tranches in some countries may in any case not necessarily hurt investor demand, in our view. While 'AAA' ratings may have been the benchmark in the securitization market historically, investor sentiment could evolve, recognizing that ratings in the 'AA' and 'A' categories, for example, still represent a very strong or strong capacity to meet financial commitments, according to our rating definitions. The covered bond market may already be demonstrating such a shift: We used to rate nearly all Spanish and Italian covered bond programs 'AAA', but issuance has continued despite the fact that ratings are now lower. Investor demand for securitizations from these countries also appears to remain strong. In fact, spreads on senior RMBS from countries where 'AAA' ratings are generally no longer achievable have actually tightened substantially over the past three or four years, despite country risk increasingly constraining our senior tranche ratings.

Better Regulatory Treatment For "Qualifying Securitizations" Could Help

Developing a set of principles that provide a common definition for "qualifying securitizations"—and an acknowledgment in regulations that such simple, transparent structures have generally performed well—could help to revive the European securitization market, in our view.

Many securitizations exhibited strong credit performance during the financial crisis. In fact, the track record of European securitizations arguably supports the idea that the poor credit performance of products related to U.S. subprime mortgage loans may have had more to do with the market structure and underlying loan origination practices at the time, rather than any inherent weakness in securitization technology itself. In Europe, the cumulative default rate of structured finance that we rated and which was outstanding in mid-2007 was only about 1.5% to the end of 2013 (when aggregated by original issuance volume), and for vanilla asset classes such as RMBS, the default rate has been substantially lower still.

We would urge some caution in interpreting historical default rate data when determining which types of securitizations to include in the "qualifying" designation. One reason for this is that observed default rates are influenced by market structure, not just the credit quality of individual transactions. For example, in an asset class where there is relatively high correlation between different securities, a moderate stress could lead to a higher default rate than in an asset class where the correlation is lower. In addition, even with the benefit of hindsight, it can be difficult to assess whether an observed historical decline in underlying collateral performance, for example, was or was not "predictable" at the time. In summary, some simple and transparent securitizations could in future see a high default rate if they were to undergo an unusually extreme stress event, or if many of the transactions had similar characteristics.

We agree that a "qualifying securitization" designation should not aim to provide an opinion on credit risk, but rather signify that the assessment of those risks may be relatively straightforward. As a result, we agree that the designation should ideally apply to whole transactions, rather than individual tranches. Although it is likely that certain regulations may build on the "qualifying securitization" definition and overlay additional tranche-specific

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requirements, we believe that keeping the overall definition at a transaction level reduces the risk of undermining the market for mezzanine and junior securitization tranches, which is important when using securitization for risk transfer.

The "qualifying securitization" concept could act as a useful starting point in certain rule-based applications, in our view—especially for central banks and regulators. The approach may be particularly suited to applications in which there is a binary consideration, such as whether a security should or should not be eligible as central bank collateral, for example.

However, most of the proposed criteria for a "qualifying securitization" are rather high-level, meaning that credit rating agencies would, in our opinion, be unlikely to use the designation in their assessment of structured finance securities' creditworthiness. We already consider the detailed features of each securitization in our ratings analysis, and a "qualifying securitization" label would likely not provide any additional information.

Finally, with regard to sovereign-related rating caps, the discussion paper suggests that credit rating agencies could publish "additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facility rating caps were to be set at higher levels". We believe country and counterparty-related risks are important in determining the creditworthiness of securitization tranches. However, for many transactions we have also since 2012 been publishing information about how our ratings might change if these risks were much lower. These analyses are available in our quarterly index report publications for most of the European RMBS tranches that we rate. We are committed to continually improving the transparency of our analysis and opinions and are open to suggestions about the wider application of such analyses to other asset classes, and about how we could present this information in the future.

14 July 2014

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Re: Comments on "The case for a better functioning securitisation market in the European Union: A Discussion Paper"

The Structured Finance Industry Group ("**SFIG**") appreciates the opportunity to comment on the discussion paper (the "**Paper**") issued jointly on May 30, 2014 by the Bank of England (the "**BoE**") and the European Central Bank (the "**ECB**") regarding the case for a better functioning securitization market in the European Union.[1] SFIG wishes to express its appreciation for the efforts of the BoE and ECB that produced this Paper and strongly supports initiatives to strengthen the global securitization market. Our views as expressed in this letter are based on feedback received from our broad membership.

I. Introduction

SFIG's membership includes, among others, (1) US-based issuers of asset-backed securities ("**ABS**") that may from time to time sponsor or offer ABS to EU investors, (2) US-based investors that may from time to time invest in ABS issued by EU-based issuers, and (3) financial intermediaries that support such issuances or investment activities. US industry participants are impacted by how well the EU securitization market functions because, among other things, the European market:

[1] SFIG is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitisation market. SFIG provides an inclusive network for securitisation professionals to collaborate and, as industry leaders, drive necessary changes, be advocates for the securitisation community, share best practices and innovative ideas, and educate industry members through conferences and other programs. Members of SFIG represent all sectors of the securitisation market including issuers, investors, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers, and trustees. Further information can be found at www.sfindustry.org.

- creates a diversification of investment opportunities for US investors in ABS;
- provides an additional source of investor demand for US issuers of ABS;
- increases the supply of high-quality, liquid assets available to all market participants; and
- benefits from access to the deep and diversified pool of US fixed income investors, as funding for European originators of ABS shifts toward a more market-based approach and central bank intervention decreases.

Further, we are mindful that significant changes to the European securitization regulatory framework could impact the activities of US investors and the perception of US issuers and that these changes will constitute an important part of the global policy debate. We seek actively to participate in this global policy debate and are currently helping to coordinate the US effort to complete the market survey recently released by the International Organization of Securities Commissions ("**IOSCO**") and the Basel Committee on Banking Supervision, which focuses on themes similar to those addressed in the Paper.

The following comments include responses to questions asked in the Paper that we believe we are well situated to answer given the nature of our members and their interests (and we identify these questions using italicized font in the relevant parts below as well as provide an index of our responses in Annex A attached hereto). This letter does not intend to respond to questions posed in the Paper that we believe are more suitably addressed by market participants based in the European Union.

II. Comments on behalf of SFIG's members pertaining to their interests in the European ABS market

SFIG's membership strongly supports EU policy initiatives and regulatory change aimed at improving the functioning of the EU securitization market. Securitization is an important source of financing for the real economy and supports the economic recovery both domestically and globally.[2] It is a significant tool for capital raising for providers of credit, which can drive growth in the real economy, and for risk transfer from originators of financing products to the capital markets. Due to the global nature of our financial system, securitization, in order to be most effective, requires seamless operation across borders. In fact, IOSCO in its November 2012 report on global developments in securitization regulations (produced at the direction of the Financial Stability Board) states that "[c]ross border activity is an important component of global securitisation markets".[3]

- ➢ The next three paragraphs respond to this question in the Paper: *"Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?"* We generally agree and would like to especially highlight the following benefits:

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2 *See, e.g.*, International Organisation of Securities Commissions, Global Developments in Securitisation Regulation: Final Report, 9 (Nov. 16, 2012) (available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD394.pdf) (the "IOSCO Final Report").

3 *Id*. at 10.

A well-functioning EU ABS market would diversify the sources of capital available to the real economy by increasing non-government funding sources. Securitization allows originators of loans or credit facilities provided to consumers and "end user" businesses to finance in an efficient and cost-effective manner a wide range of assets that can drive economic growth by offering securities backed by pools of these assets (*e.g.*, auto loans and leases, commercial loans, residential and commercial mortgages, and credit card receivables) to a broad range of investors. Where these originators are not regulated banks, the credit they provide complements the capital traditionally provided by regulated banks. Securitization is a particularly important funding tool for these non-bank credit providers that do not have access to a deposit base for cost-efficient funding. A well-functioning EU ABS market that includes a private, fixed-income investor base willing to invest in EU ABS transactions would increase access to, and diversification of, funding sources for non-bank issuers, as market reliance on central bank intervention decreases.

A well-functioning EU ABS market would provide important investment opportunities to US institutional investors. During periods of greater market issuance of ABS by European originators, US institutional investors historically constituted a significant portion of the primary market demand. We believe that an increase in cross-border ABS offerings as part of a well-functioning EU ABS market would be welcomed by these US investors as presenting important investment opportunities.

A well-functioning EU ABS market would increase availability of safe assets. High-quality, liquid assets ("**safe assets**") play an important role in a well-functioning global financial system because they: (1) can be used as a source of steady income and capital preservation in portfolio construction; and (2) serve a critical function as high quality, liquid collateral in a wide range of financial transactions. Privately issued assets, such as high-quality ABS, represent an important source of safe assets.[4] One clear policy response to the recent global financial crisis has been to make financial institutions more resilient, in part by incentivizing these institutions to hold safer financial assets.[5] The International Monetary Fund ("**IMF**") has reported that demand for safe assets increased at the same time that the supply of safe assets generally decreased.[6] The overall decline in privately issued safe assets since the global financial crisis has contributed to an imbalance of supply and demand for safe assets. Unmet demand for safe assets drives up the price of safety, leading investors that are unable to bear the higher cost of safety to settle for assets that embed higher risks than desired.[7] Demand-supply imbalances in the market for safe assets could also cause "more short-term volatility jumps, herding, and cliff effects."[8] Accordingly, US as well as EU market participants would welcome additional sources of privately issued safe assets coming from a well-functioning EU securitization market.

- ➢ The following discussion responds to these two questions in the Paper: *"Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?"*

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4 *Id*. at 3 (reporting that securitized instruments accounted for 17% of the global aggregate supply of safe assets).

5 *See* International Monetary Fund, Global Financial Stability Report: The Quest for Lasting Stability, Ch. 3 (April 2012) (available at http://www.imf.org/external/pubs/ft/gfsr/2012/01/pdf/text.pdf) .

6 *Id*. at 2.

7 *Id*. at 32.

8 *Id*. at 33.

and *"Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?"*

Standardization can be a useful technique for increasing market confidence and liquidity. Mature, liquid financial markets are often characterized by market-driven standardization. When warranted, initiatives to standardize financial instruments can promote market confidence and liquidity. As the Paper notes, the European market for ABS could benefit from increased market confidence and liquidity, and in that light, regulatory incentives that promote standardization appear to be promising. In particular, we recognize a need for developing a more robust fixed-income investor base in the European Union willing to invest in EU securitization transactions. We would like to highlight, however, that we do not believe that secondary trading is a reliable indicator of liquidity. We believe an ABS instrument should be considered liquid when it can be converted into cash in a short period. For example, we would consider high-quality ABS to be liquid if sufficient investors would be willing to purchase the ABS when it is offered, even when there is otherwise typically little active secondary market trading in the ABS because investors prefer to hold the ABS after purchase.

A qualifying securitization regime will be most effective if market participants have certainty early on as to a qualification certification. In its response to the Paper, the Association for Financial Markets in Europe ("**AFME**") includes in its overall comments that "there should be certainty surrounding the categorization of each transaction. … [P]arties to a securitisation transaction need to be able to have a high degree of certainty early on as to whether the transaction is likely to fall within [the qualifying] category." We strongly concur with this general comment and believe that investors will need such certainty at the very latest at the time they make their investment decision.

- The remainder of this section responds to these questions in the Paper: *"With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?"* and *"Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?"* and *"These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?"*

Standardization should reflect an industry consensus. We believe that initiatives intended to promote market confidence and liquidity are most effective when they are driven by market participants. We recommend that relevant EU policy makers and regulators, when seeking to leverage the benefits of standardization to build market confidence and liquidity, consider reliance on industry participants to develop consensus-based standards that present realistic requirements for issuers and provide proportionate value to investors. We note that some asset classes may be less susceptible to standardization due to differences in originators' business practices and supporting systems. Standardization developed by market participants at a principles level should allow for sufficient flexibility to accommodate these business differences.

As an example, we are currently sponsoring the development of an industry consensus regarding standardization in the US market for residential mortgage backed securities to increase market confidence and liquidity for this particular asset class. Since the fall of 2013, our RMBS 3.0 committee has been working to create consensus among participants in the mortgage backed securities market with varying interests. The goal of this industry-led initiative is to promote best practices for this asset class, including consideration of possible standardization of structures, terms and disclosures. Based on our experience with this committee, we believe that significant changes to standardize structure, terms or disclosures will be more easily implemented if the process involves building consensus among various key market participants.

Standardization should be implemented in a manner that does not unduly limit innovation. In some circumstances, however, we are concerned that standardization may limit innovation needed to appropriately address evolving conditions or opportunities in the EU ABS market, which could prevent available capital from reaching the real economy. To address this risk, SFIG recommends the following strategies to preserve healthy flexibility:

- implementing standardization as high-level principles rather than detailed prescriptive requirements;

- limiting the scope of standardization to clearly identified asset classes that are in need of increased market confidence and liquidity; and

- providing for a procedure pursuant to which exemptive relief may be obtained, where appropriate.

Market distortions could result if a significant number of securitizations that investors would generally consider to be high-quality ABS would not receive a "qualifying certification". SFIG's members generally welcome regulatory incentives for prudent underwriting of underlying assets and structuring of ABS, especially if those regulatory incentives would provide appropriate liquidity coverage ratio ("**LCR**") or capital relief for ABS that investors generally consider to be high-quality ABS. In its response to the Paper, AFME notes: "The function of any efficient market is to price and allocate risk, not eliminate it." We strongly agree with this statement. We understand the risk of ABS to be a function of the combination of (1) underlying asset quality and (2) structural protections and subordination levels. In light of this understanding, we are somewhat concerned that the "simple and transparent" principle identified in the Paper as a key criterion for the "qualifying" securitization definition may not adequately give credit to structuring elements that would reduce risk. Significant, unintended market distortions may result if, due to inflexible definitions, relatively higher risk ABS are provided advantageous LCR treatment or greater capital relief, while lower risk ABS involving more complex structural protections are not accorded similar treatment. We believe that "transparency" is a much more relevant standard and that all such structural protections should be disclosed to investors in a clear and readily understandable manner.

Coordination among international regulators is critical to well-functioning global ABS markets. Securitization is an important technique for financing the real economy and supporting economic recovery.[9] IOSCO's 2012 report includes the following recommendation: "Regulators should seek to minimize the potentially adverse effects to cross-border securitization transactions

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[9] *See, e.g.*, IOSCO Final Report at 9.

resulting from differences in approaches to incentive alignment and risk retention."[10] If EU regulatory approaches for developing a well-functioning EU securitization market differ significantly from regulation of ABS issuers and markets adopted by other major jurisdictions, such as the United States, securitizers seeking to sell ABS interests in cross-border transactions may need to comply simultaneously with non-aligned requirements of multiple jurisdictions. Even if securitizers are able to comply with multiple sets of regulations, it is very likely that the related increased compliance costs will be ultimately passed on to consumers and "end user" businesses and the broader economy. This could include an increase in financing costs and a decrease in credit availability to consumers. It is possible that a significant number of securitizers would choose to avoid offering their ABS interests in cross-border transactions, which could negatively impact markets market by:

- decreasing the diversity of assets available to investors;
- decreasing the supply of safe assets available in the market; and
- impeding efficient price discovery.

Accordingly, SFIG recommends that relevant EU regulators considering implementation of the incentives discussed in the Paper reduce the potential pressure placed on cross-border securitization markets from non-aligned regulatory structures by coordinating their regulatory initiatives with their non-EU counterparts in other key jurisdictions. Early and efficient coordination of regulatory reform across borders would help ensure that regulatory arbitrage does not pose a risk to the global financial system. Such coordination would also allow for early identification and mitigation of negative extra-territorial effects of inconsistent regulatory actions on the financial sector.

For example, US regulators involved with implementing new regulatory regimes for over-the-counter swaps and security-based swaps have been coordinating with regulators in other key jurisdictions (including, among others, Europe, Canada, Australia and Japan) to develop common policy understanding and adopt regimes that contemplate substituted compliance with comparable regulation.[11] We would recommend that relevant key international regulators similarly develop a common policy understanding related to the definition of "qualifying" securitizations and related regulatory incentives, which would include the possibility of substituted compliance with comparable regulation.

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[10] *Id*. at 48.

[11] *See* Commodity Futures Trading Commission, Press Release: "CFTC Approves Comparability Determinations for Six Jurisdictions for Substituted Compliance Purposes" (Dec. 20, 2013), available at http://www.cftc.gov/PressRoom/PressReleases/pr6802-13; Securities and Exchange Commission, Release No. 34-72472, Final Rule: "Application of Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities, available at http://www.sec.gov/rules/final/2014/34-72472.pdf.

III. Comments related to the potential application of the "qualifying" securitization concept to US transactions

- The following section responds to this question in the Paper: *"Do respondents have any comments on the principles in Box 3?"*

As discussed above, we recommend keeping the "qualifying" securitization definition at a *principles* level to preserve healthy flexibility in the European market, allowing the development of new types of high-quality securitizations that meet the needs of lenders to the real economy. In particular, we believe that standardization of ABS as contemplated by the Paper is not as relevant to the US market, given the anticipated adoption of Regulation AB II and other market initiatives, such as RMBS 3.0 (discussed above). Despite the global financial crisis, US markets for ABS have remained far more liquid and issuance programs/asset classes have remained far more diverse than in the European Union.

It is very important to assess fully the possibility that well-functioning or growing markets for certain asset classes or structures suffer from an implicit "scarlet letter" effect, should they not fall within the category of a standardized "qualifying" securitization. US investors may need to implement additional approvals processes or portfolio limitations if too narrow a definition of "qualifying" securitization is implemented, to manage stigma that may become associated with "non-qualifying" ABS.

To assist in the evaluation of the proposed principles, we have surveyed four existing ABS issues used to finance credit card and auto industry related receivables, which we consider to be representative of high-quality ABS in their respective asset class. Additional details regarding these securities and the results of our analyses are provided in Annex B attached hereto. We note that several of the proposed criteria for "qualifying" securitizations contemplate characteristics or practices that are not currently market practice and may be very costly to implement without necessarily improving the pricing or reducing the risk of the ABS. Even when the criteria for a "qualifying" securitization are appropriately selected and defined, we are concerned that significant transition issues may arise with respect to legacy ABS. Without appropriate phasing-in of any new requirements, the implementation of these criteria could cause market distortions as legacy ABS that investors would have otherwise considered to be high-quality ABS becomes less attractive as compared to more recently issued "qualifying" ABS.

The following points discuss how certain high-quality US asset classes of ABS could have difficulty satisfying a number of the proposed principles set out in Box 3 of the Paper.

- ***Self-liquidating from intrinsic cash flows***: Certain asset classes, especially those involving the securitization of leases and related residual values of autos or equipment, present a payment structure that is primarily (but technically not 100%) self-liquidating from intrinsic cash flows. For example, securitizations of auto leases that include the residual value of the leased vehicle are primarily self-liquidating as lease payments are made, while the payment of the related securitized residual value would depend on sale proceeds after lease termination. Another example is securitizations that include balloon payment obligations that are settled with proceeds of the sale of the financed property. These asset classes may be considered high-quality by investors even though they involve an element that is not self liquidating. We suggest that these types of asset classes should not be required to meet the self-liquidating criteria.

- ***Current in payment at time of transfer into the securitization***: Market participants customarily test asset eligibility as of a cut-off date that is typically up to 30 days (in some instances this time period has been up to 90 days) before the date that assets are transferred into a securitization. We suggest that this criteria take this market practice into account. We also note that assets that are less than 30 days delinquent are frequently considered eligible for transfer into a securitization. To avoid implementation of overly burdensome additional verification procedures and disadvantaging legacy ABS, we recommend that "current at the time of transfer" be construed broadly enough to include assets that were less than 30 days delinquent as of a date reasonably close to the transfer date.

- ***Verifiable loan loss performance covering at least one period of significant market stress***: This particular principle is likely to become more difficult to satisfy in the future, as it will become less clear whether periodic economic recessions will constitute "significant market stress". We suggest qualifying this principle with a cut-off date, such that it would not require loan loss performance data for any period more than five years prior to the date of issuance. In addition, we are concerned that this principle would present a barrier to entry for emerging asset classes and for new originators. We note that it is likely that significant comparability issues would arise for longer periods as underwriting standards change to accommodate evolving market practices and/or regulatory developments. It would be helpful to have clarification as to what verification procedures are contemplated with the reference of "verifiable" in this standard.

- ***Recourse to primary obligors for underlying assets***: With respect to US RMBS issuances, at least a dozen US states do not permit recourse to the primary obligors. We recommend that regulators consider adopting an exception to this criteria if recourse to primary obligors is not permitted by relevant home-country law.

- ***Full range of disclosures conforming with the EU Prospectus Directive***: We recommend EU regulators consider permitting compliance with US disclosure requirements in lieu of the EU Prospectus Directive to satisfy this criteria in cases where the EU Prospectus Directive does not apply by its terms and more than a *de minimis* amount of an offering is sold by a European issuer to US investors or in cases of offerings by US or other non-European issuers in part into the European market. In addition, this criteria reflects a standard that applies to a publicly offered transaction that is often not implemented in the context of privately placed ABS (*i.e.*, only to institutional investors). It would be unduly burdensome to require this criteria to be implemented in the private placement context in order for otherwise high quality ABS to be considered "qualifying" securitizations.

- ***Ongoing reporting of loan-level performance data***: This type of reporting is currently not required, or market practice, in the United States for most asset types.

- ***Documentation and terms reviewed and verified by an authorized legal practice; transaction terms and reports reviewed by an accountant or calculation agent***: We are not aware of any requirement, or market practice, in either the United States or the European Union that would satisfy these criteria. Depending on the scope of any required certifications and any related liability risk, it is unclear whether these third party service providers would be willing to provide such services and, if so, whether they could do so at a reasonable cost. In addition, we note that some issuers rely on internal departments to serve the calculation agent role.

- ***Ongoing credit assessment by two external credit assessment institutions***: Under US law, ABS issuers are not required to obtain ratings from two rating agencies if a rating is obtained. Accordingly, US ABS may be only rated by one rating agency. In fact, reliance on credit assessments by external credit assessment institutions as a proxy for creditworthiness in a regulatory context would run counter to the US public policy reflected in Sections 939 and 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. In addition, this criteria reflects a market practice that is customary for a publicly offered transaction. Many private placements of ABS are not rated at all. It would be unduly burdensome to require this criteria to be implemented in the private placement context in order for otherwise high quality ABS to be considered "qualifying" securitizations.

IV. Conclusion

In summary, our responses to the Paper include, among others, the following key recommendations:

- keep the "qualifying" securitization definition at a *principles* level to preserve healthy flexibility in the European market, allowing the development of new types of high-quality securitizations that meet the needs of lenders to the real economy;

- when seeking to leverage the benefits of standardization to build market confidence and liquidity, consider reliance on industry participants to develop consensus-based standards that present realistic requirements for issuers and provide proportionate value to investors;

- provide market participants with certainty early on as to a qualification certification; and

- reduce the potential pressure placed on cross-border securitization markets from non-aligned regulatory structures by coordinating EU regulatory initiatives with non-EU counterparts in other key jurisdictions.

We greatly appreciate your consideration of our members' comments. Please do not hesitate to contact Richard Johns at 202-524-6301 should you have any questions in connection with this letter.

Very truly yours,

Richard Johns
Executive Director

Annex A

Index of Questions and Responses

Questions in the Paper		Page(s) of this Letter on which Response Appears
1.	Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?	3-4
2.	Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?	n/a
3.	Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?	n/a
4.	Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?	4
5.	The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?	7-9
6.	Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?	4
7.	These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?	4-6
8.	Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?	n/a
9.	Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardized investor reports in a single location be helpful to securitisation markets?	n/a
10.	Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?	n/a

Questions in the Paper		Page(s) of this Letter on which Response Appears
11.	In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?	n/a
12.	Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?	n/a
13.	Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?	n/a
14.	How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?	n/a
15.	With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?	4-6
16.	Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?	n/a
17.	Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?	n/a
18.	Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?	4-6

Annex B

Evaluation of Examples of ABS Transactions Involving Auto and Card Assets

	Ford US Auto ABS (1)	Ford EU Auto ABS (2)	GM EU Floorplan ABS (3)	Chase US Credit Card ABS (4)
I. Underlying Asset Characteristics				
• Credit claims or receivables with terms relating to either (1) rental payments or (2) principal and interest payments	Yes	Yes (5)	Yes	Yes
• Any interest payments are based on commonly encountered market interest rates (may include caps and floors, but not complex formulae or exotic derivatives)	Yes	Yes	Yes	Yes
• Homogenous in asset type	Yes	Yes (6)	Yes	Yes
• Consistently originated in the ordinary course of the originator's business involving either (1) obligors satisfying prudent and consistent underwriting criteria or (2) granular pools of retail consumers for which expected cash flows can meet the securitization's stated obligations under prudently stressed loan loss scenarios	Yes (7)	Yes (7)	Yes (7)	Yes (7)
• Current in payment at time of transfer into the securitization	Unclear (8)	Unclear (8)	Yes (9)	Yes (10)
• Self-liquidating from intrinsic cash flows (may not rely on future borrowings or asset sales for timely payment of interest and principal)	Yes	Yes (11)	Yes	Yes
II. Structure & Disclosures				
• Structure is simple (not overly complex)	Unclear (12)	Unclear (12)	Unclear (12)	Unclear (12)
• Verifiable loan loss performance for substantially similar receivables / assets for a time period covering at least the effective life cycle of the assets	Yes	Yes	Unclear (13)	Yes

	Ford US Auto ABS (1)	Ford EU Auto ABS (2)	GM EU Floorplan ABS (3)	Chase US Credit Card ABS (4)
• Verifiable loan loss performance for substantially similar receivables / assets for a time period covering at least one period of significant market stress	Yes (14)	Yes (14)	Unclear (13)	Yes (14)
• Recourse to primary obligors for underlying assets (no reliance on derivative-linked claims or a securitization of other securitizations)	Yes	Yes	Yes	Yes
• If underlying assets are secured on specified tangible assets, security is first-ranking (or other higher ranking rights are also transferred to the securitization)	Yes	Yes	Yes	Yes
• True sale of the underlying assets, confirmed by a legal opinion, such that the transfer is: • enforceable against any third party; • beyond reach of seller, its creditors or liquidators; • not effected though CDS or derivatives; and • not subject to identifiable re-characterization or claw-back risks.	Yes (15)	Yes (15)	Yes (15)	Yes (15)
• Ongoing reporting of loan-level performance data to current and potential investors on a monthly / quarterly basis throughout the life of the securitization	No	Yes	No	No
• Ability to distinguish and report all income and disbursements	Yes	Yes	Yes	Yes
• Initial loan-level or granular pool stratification data intended to permit potential investors to construct and analyze cash flow models	Yes (16)	Yes	Yes	Yes (16)

	Ford US Auto ABS (1)	Ford EU Auto ABS (2)	GM EU Floorplan ABS (3)	Chase US Credit Card ABS (4)
• Clear and consistent definitions for debtor payments, payment priorities and other rights	Yes	Yes	Yes	Yes
• Documentation and terms reviewed and verified by an authorized legal practice	Unclear (17)	Unclear (17)	Unclear (17)	Unclear (17)
• Transaction terms reviewed by an accountant or calculation agent	No	No	No	No
• Reports reviewed by an accountant or calculation agent	No	No	No	No (18)
• Full range of disclosures conforming with the EU Prospectus Directive	No (19)	Yes	Yes	No (19)
• Transaction level information provided on identity, roles and responsibilities of all transaction parties, including servicers and counterparties	Yes	Yes	Yes	Yes
• Servicer applies same servicing policies, procedures and standards to the underlying assets that it applies to similar non-securitized assets	Yes	Yes	Yes	Yes
• Documentation includes provisions for the replacement of servicers, derivative counterparties and liquidity providers in the event of breach or deterioration of creditworthiness of any such counterparty to the securitization	Yes (20)	Yes (20)	Yes (20)	Yes (20)
• Ongoing credit assessment by two external credit assessment institutions	Yes	Yes	Yes	Yes (21)

Notes

(1) Multiple classes of asset backed notes with a range of final payment dates issued by Ford Credit Auto Owner Trust 2014-B issued on June 24, 2014 (financing a pool of car, light truck and utility vehicle receivables purchased by Ford Motor Credit Company LLC from dealers).

(2) Asset backed notes due April 20, 2022 issued by Globaldrive Auto Receivables 2014-A B.V. on May 28, 2014 (financing receivables under German law governed retail auto loan agreements, originated in Germany by FCE Bank plc through motor vehicle dealers).

(3) EMOT 2012-1 Asset Backed Notes due June 17, 2016 issued on April 26, 2012 (financing automobile dealer floorplan receivables from GMAC Banque and GMAC Bank GmbH).

(4) Multiple classes and tranches of CHASE series notes issued by Chase Issuance Trust from time to time, backed by credit card receivables owned by Chase Bank USA, National Association or by one of its affiliates.
(5) This response assumes that loans to retail customers with balloon payments would be considered a receivable that meets this criteria.
(6) This response assumes that loans to retail customers with balloon payments would be considered homogenous with fully amortizing loans to retail customers.
(7) These responses assume that "consistently originated", "consistent underwriting standards" and "prudently stressed" would be interpreted broadly. Additional clarification as to the intended scope of these concepts would be helpful, as such standards may change over a period of several years to reflect changes in market practice or in response to regulatory developments.
(8) Underlying assets were eligible for transfer into this securitization if they were less than 30 days delinquent as of the cut-off date, which was a date within 30 days of closing.
(9) Only current assets are contributed when using a revolving master trust structure.
(10) Any new receivables generated in accounts that have been designated to the securitization trust are, by definition, current. At the time of an addition of an account to the trust, however, the account might have receivables that were delinquent and still satisfied the criteria for eligible account as defined in the relevant transaction documents.
(11) This response assumes that the settlement of a balloon payment obligation from the proceeds of the sale of the financed vehicle would qualify as "self-liquidating".
(12) This criteria appears to be highly subjective and would benefit from additional high-level guidance / definition to enable a meaningful evaluation.
(13) Historic loan loss data is not available because loan losses have been zero.
(14) These responses assume that disclosure covering the five years prior to issuance satisfies this criteria. It is unclear whether it would be as easy to satisfy this criteria in future issuances, and it is unclear whether an economic recession would qualify as a period of "significant market stress".
(15) These responses assume that this criteria would be met even if the relevant "true sale" legal opinion included the customary, generic exception regarding the operation of re-characterization or claw-back rules in the bankruptcy context.
(16) These responses assume that transactions including only standard stratification data of whole pool would qualify under this standard.
(17) It is unclear what type of review and verification process would be required. While law firms were involved in the preparation of transaction documentation, no affirmative certification of verification was provided.
(18) Accountants are engaged to perform annual attestations pursuant to Regulation AB, which includes review of a sample of monthly servicing reports for the relevant calendar year.
(19) The disclosure requirements of the EU Prospectus Directive did not apply to this offering because these ABS were not publicly offered in the European Union. Instead, the prospectus for this offering complied with applicable US disclosure standards.
(20) These responses assume that this criteria does not require pre-identification of a back-up / alternate servicers, counterparties or liquidity providers.
(21) While the program documents for this securitization only require one rating, each tranche of notes publicly issued out of this securitization program is currently rated by one, two or three rating agencies.

REGERINGSKANSLIET
Ministry of Finance

Financial Institutions and Markets
Dnr: Fi2014/2502

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Comments by the Swedish Authorities' to the joint ECB-Bank of England discussion paper on the securitisation markets in Europe

The Swedish Ministry of Finance and Sveriges Riksbank (the Swedish Central Bank) - hereinafter Swedish authorities - appreciate the opportunity to provide comments to the joint ECB-Bank of England discussion paper entitled "The case for a better functioning securitization market in the European Union".

Swedish authorities generally support initiatives to increase transparency and standardisation of securitisation as this can enable investors and supervisors to better identify the underlying risks. We also agree that a differentiation of funding sources can have positive effects on financial stability as risk is spread more efficiently across sectors. The Swedish authorities welcome a discussion on the developments of the EU securitisation market and agree that securitisation in its original form (i.e. unlevered and based on true sales on the part of the originating institution) can constitute an important alternative funding source for banks, for instance when providing loans to small and medium-sized enterprises (SMEs).

In our view, however, the most important precondition for ensuring the credit provision to SMEs in the long run is the safeguarding of financial stability, including a well-capitalised banking system. This in turn requires adequate regulations across the entire chain of credit intermediation (including issuers, intermediates, and final investors). Ensuring robust, trustworthy and stable regulations for banks, insurance companies and other financial institutions should therefore be a precondition for credit provision.

It is also important to note that the aggregate credit risk does not decrease when assets are securitised and removed from banks balance sheets, but is merely spread out across sectors. Risks and risk concentration will be more difficult to monitor if it shifts into the shadow banking system. Moving aggregate credit risk out of the banking system will also decrease the effect of macroprudential tools directed at banks, e.g. capital buffers and risk weight floors. As such, securitisation could have adverse effects on financial stability and does not necessarily reduce taxpayers' contingent liabilities from dealing with financial instability.

In order to incentivise market participants to issue simple and transparent securitisations, Swedish authorities see merits in identifying and differentiating the regulatory treatment for so called qualifying securitisation. Nevertheless, before promoting changes to the current or forthcoming regulation it is important to ensure that any policy actions taken leads to the desired outcome and that the benefits of action taken outweigh the costs in terms of financial stability. Hence, we should carefully consider the incentives already in place, with regards to both current and upcoming regulation as well as to other policy initiatives taken by public authorities before further action is taken.

In this context we also like to point out that the guiding principle when designing the regulatory framework should be to ensure that all risk entailed in securitisation products is reflected. As such, considering a differentiation of capital and other prudential requirements should not automatically imply a lowering of requirements for simple, transparent and robust securitisations, but potentially an increase in requirements for the more complex products.

At a more technical level, Swedish authorities note that as for the proposed principles of a qualifying securitisations outlined in Box 3, it might be appropriate to consider additional criteria as well, such as maturity matching and a minimum amount of risk retention. Moreover, a comparison across different asset classes should be comprehensive and account for all relevant aspects, including market liquidity, risk and dynamics of the underlying pool as well as model risk.

Based on the important differences in characteristics between covered bonds and securitised products, the Swedish authorities are sceptical to the appropriateness of a uniform regulatory treatment of covered bonds and qualified asset-backed securities, as suggested in paragraph 69 of the paper.

In summary, the Swedish authorities welcome the initiative to strengthen the efficiency and resilience of the European securitisation market. In order to achieve those objectives, however, the design of the regulatory framework should be based on a thorough analysis of benefits and costs, taking into account effects on the real economy, financial stability and consumer protection.

We also believe that is important to recognise that a revival of the securitisation market will not by itself solve the current problem related to credit provision to SMEs in the EU. Instead a functioning securitisation market should be seen as complement to conventional bank lending. Therefore, potential policy actions for the securitisation market should not be seen in isolation but needs to be considered in a broader context. This includes taking implications for the whole financial system into account and keeping in mind that the most important prerequisite for sustainable credit provisioning to real economy is a healthy and resilient banking system.

Stockholm, 4 July 2014

Ministry of Finance

Pål Bergström

Director General – Financial Institutions and Markets

Sveriges Riksbank

Martin W Johansson

Acting Head of Department – Financial Stability Department

TSI comments on the BoE / ECB discussion paper "The case for a better functioning securitisation market in the European Union"

(May 2014)

TSI welcomes the opportunity to comment on the Bank of England and the European Central Bank discussion paper “The case for a better functioning securitisation market in the European Union” published in May this year. We regard the paper as an excellent and comprehensive starting point for further discussion on high quality securitisations.

1. Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?

Yes. In particular, we would like to refer to the following benefits of securitisation in a well-functioning securitisation market:

- To support and improve the financing of the real economy and thus to contribute to growth and employment in the European Union by converting non-tradable financial assets into securities that can be issued to investors and traded on capital markets;
- To broaden the investor base, to diversify the sources of funding and thus reduce the liquidity risks of originators while lowering the funding costs and thus the financing costs for SMEs, which in turn would contribute to stabilising the whole economy;
- To increase market liquidity, thus increasing the attractiveness for investors and contributing to a robust market with unbiased market prices that appropriately reflect the risks without bias. Increased liquidity would contribute to reducing the liquidity risks of investors which would be justifiably given preferential treatment, under Solvency II and the LCR for example, as high liquid assets as well as in terms of the capital requirement for the trading book and the eligibility as collateral for derivatives. This would reduce counterparty credit risks [EMIR], which in turn would boost market liquidity and contribute to deepening the market (self-amplifying effect);
- To support the diversification of investment portfolios and thus reduce systemic risks due to overreliance on asset classes that were liquid in the past but will not necessarily prove to be liquid in the future;

- To free capital by risk transfer, enabling banks to finance SMEs at reduced costs in the light of increased capital requirements and thus to enable SMEs to participate indirectly in the benefits of the capital market;
- Lowering the vulnerability of the originators' funding means that, as a result of different idiosyncratic risks, that funding is independent of the originator's rating;
- Less encumbrance of the balance sheet compared to covered bonds, thus contributing to greater financial stability. (Supervisory authorities, including recently BaFin, ESMA and ESRB, are increasingly acknowledging the phenomenon of asset encumbrance and addressing it as a matter for discussion. Asset encumbrance is a dynamic phenomenon and is not restricted solely to overcollateralisation at the time of the bond placement but is also related to the behaviour of the issuers in the case of a worsening of creditworthiness and to the criteria set by the rating agencies, in that the amount of overcollateralisation required to achieve or maintain a specific target rating comes into play. In the light of the actual banking restructuring discussion, the advantages of securitisations with regard to asset encumbrance should automatically come to the fore.)
- The securitisation market comprises a long and medium-term (ABS) market and a short-term (ABCP) market. We would also like to draw your attention to the importance of the ABCP market for the real economy. ABCP programmes are used to finance trade receivables (and to a lesser extent lease and consumer receivables) originated by the real economy. According to information available from rating agencies, as of the end of 2013 ABCP programmes sponsored by the six leading German ABCP banks provided real economy companies with committed financing of up to approximately EUR 10 billion. Consequently, real economy companies would benefit directly from a well-functioning ABCP market as they would have the advantages of a deeper ABCP market and lower ABCP spreads.

2. Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?

Answer to the first question

Yes. The main points are still as follows:

- The revised capital requirements proposed by the Basel Committee are significantly too high in relation to their risks, even if the risk weight were lowered from that proposed in the first draft to the securitisation framework. This applies, in particular, to high quality ABS and high quality ABCP with simple and robust structures. Model risks are significantly overestimated. Thus, floors and capital requirements for securitised loans compared to non-securitised loans are significantly too high. As a result, the higher capital requirements proposed by the Basel Committee seven years after the outbreak of the subprime RMBS crisis in the USA would extremely impede the recovery of the market and exacerbate the present situation; as a result of Basel III and increased capital requirements for significant banks, the availability of sufficient equity is a bottleneck;
- The revised capital requirements as proposed by the Basel Committee are endangering the ABCP business. In relation to high quality ABCP programmes in which the sponsors provide full support and bear the credit risk of the financed asset portfolios of the real economy originators, full support requires banks to provide credit facilities which would potentially fall within the scope of the increased capital requirements for securitisations. This would result in increased funding costs for real economy originators and could even result in a scenario in which a bank would have to apply higher risk weights when financing an originator's granular high quality asset portfolio of than when financing the originator unsecured. The possibility to provide

cheap financing for originators through ABCP programmes would be restricted;

- Capital requirements under Solvency II are still too high for ABS and ABCP. This applies even for high quality Type 1 ABS and ABCP, especially in relation to covered and corporate bonds. In addition, the market will be distorted by the exemption for sovereign bonds. Finally, capital requirements for junior high quality ABS tranches with, for example, a single A rating will be subjected to capital requirements that are far too high and will prevent insurance companies from investing in such products. For instance, the capital requirements being discussed for a junior bond with a quality step 2 and term of five years would result in a capital requirement of 83%! This will endanger the marketability of even high quality ABS transactions because junior tranches are an integral and indispensable part of such transactions;
- In relation to ABCP programmes it has already been recognised by German and European regulators that standardised loan-by-loan reporting is not applicable. This is because ABCP programmes are secured by various portfolios of different originators and may comprise different types of receivables. Furthermore, the underlying transactions are revolving (in relation to trade receivables, fast revolving) and include a vast number of individual debtors which may change monthly or even weekly. We believe that aggregated reporting that shows the relevant performance for each transaction in compliance with the reporting requirements of the CRR provides investors with the relevant information in a clear manner. Providing too much information may even reduce the clarity and therefore have a negative impact. Furthermore, in relation to ABCP, the assets securitised are receivables originated by the real economy.

On the other hand, in terms of investor reporting as a result of standard setting for robust high quality ABS such as TSI and PCS, a considerable amount of standardisation has now been reached so that we see no need for further standardisation. Moreover, we recall the enormous efforts that have been made to deliver loan-level data to the ECB and the Bank of England as part of a process that has just started. We therefore recommend waiting for the outcome of the experience with the loan-level data before launching a new initiative.

<u>Answer to the second question</u>

Yes. The main points are as follows:

- Although we appreciate the intention of the European Commission with regard to the eligibility of high quality ABS as high liquid 2B assets, the cap of 15% for all level 2B assets together is significantly too low and will result in many level 2B assets meeting the eligibility criteria not being used. Thus, the positive signal sent by the eligibility of level 2B assets will have no positive impact on the costs of funding;
- According to the draft of the Money Markets Funds Regulation, money market funds will not be permitted to invest in ABS if the maturity of the underlying asset is more than 397 days, even if the ABS are eligible as high liquid level 2B assets and are of the highest quality. This is not reasonable and would reduce the investor base and market liquidity. Furthermore, it should be made clear that money market funds may invest in ABCP where trade, lease, loan or consumer receivables are underlying;
- The capital requirements being discussed for ABS under the trading book review would impede market liquidity;
- There is no level playing field in relation to covered bonds because their treatment is significantly preferential compared to that of high quality ABS. That distorts the market and impedes the establishment of a well-functioning ABS market. Examples are significantly higher capital requirements for high quality ABS under both the Basel Committee and Solvency II and a significant less favourable treatment under the LCR in terms of the eligibility of high quality liquid assets; this should be ended. As long as this asymmetric regulatory treatment of similar risks continues, there will continue to be massive effects on institutional investors' portfolio allocation, i.e. they will shy away from ABS and be attracted by whole loans/portfolios of whole loans and covered bonds. This development will substantially hinder a recovery of

the securitisation market and will be to the detriment of financial stability and transparency;

- There is no level playing field for sponsor banks' ABCP and unsecured lending business. Conversely, the capital requirement for a loan granted directly to a company and a loan granted by an ABCP programme sponsor to the ABCP programme to finance a company are not only treated in terms of the internal default probability and credit quality, but are subjected to different treatment merely because of their different legal status. As long as the risk weight for a securitisation position is significantly higher than the risk weight for an unsecured lending position, real economy originators are unable to benefit from the credit quality of their assets and banks would be discouraged from financing high quality asset portfolios rather than from granting unsecured loans;
- Information overflows due to too much information that investors have to analyse in the due diligence process. Greater importance should be attributed to the usefulness of the information in terms of its ability to enable investors to perform due diligence.

3. Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?

<u>Answer to the first question</u>

In principle, yes. However, the following points are extremely important:

Higher funding costs and worse marketability of ABS due to

- increasing capital charges under the Basel securitisation framework and Solvency II that will cause higher opportunity costs for banking and insurance investors;

- the new liquidity requirements and the intended restricted recognition of high quality ABS as high liquid assets, which will cause additional opportunity costs as part of the liquidity costs.

Unless the capital requirements are reduced, it cannot be ruled out that it will be unattractive to issue ABS because it will be too expensive from a total cost of ownership perspective.

Answer to the second question

The need to deliver loan-level data according to the ECB's specification has been fairly expensive and has required some investment in the infrastructure. Thus, new data requirements should be carefully weighed against their merits. Because the loan-level data project has been finalised, it is no longer a major issue.

Answer to the third question

See above.

General statement

It should also be borne in mind that, in terms of underlying assets, the ABS market is the most transparent market. More detailed information could deter originators from issuing ABS. Moreover, more information does not necessarily mean better information. This applies, for instance, to the information requirements recently proposed by ESMA in its draft regulatory technical standard based on Article 8b of CRA III because originators would be forced to disclose information that is both confidential and relevant for competitiveness. Such requirements are not necessary because the relevant pieces of information for investors are disclosed in the prospectus.

The most crucial factor for the revival of the securitisation market is the provision of a level playing field. As long as a lack of level playing field and asymmetric regulatory treatment of similar risks exists there will continue to be massive effects on institutional investors' portfolio allocation, i.e. they will shy away from ABS and be attracted by whole loans/portfolios of whole loans and covered bonds. This development will substantially hinder a recovery of the securitisation market and will be to the detriment of financial stability and transparency. For high quality securitisations, the regulatory capital for the senior tranche should never be higher than for the corresponding unsecuritised portfolio. Full synchronisation and full homogeneity between securitised and unsecuritised loans must be assumed.

Finally, there are renewed discussions about increased retention requirements, which alienate issuers. We are convinced that the existing rules under Article 405 of the CRR on the retained interest of issuers appropriately strike the right balance for the alignment of interests between investors and issuers. These rules should therefore not be changed.

4. Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

Yes, at least for liquidity products. For pure credit products it might not be a barrier if the products are focused on buy-and-hold investors or if the instruments have a short maturity.

5. The view of the Bank of England and the ECB is that a "qualifying securitisation" should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a "qualifying securitisation" not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

<u>Answer to the first question</u>

Yes. However, high quality ABCP should be reflected (see our answer to the third question below).

Answer to the second question

Although simplicity, structural robustness and transparency are important characteristics by which to identify qualified securitisations, which might make risk assessment easier, the most important characteristic of a qualified securitisation is either its function of refinancing an activity of the real economy or the transfer of credit risk arising from lending to consumers or corporates. If, for example, a certain level of complexity in a transaction is a result of compliance with the legal requirements of one of the European jurisdictions necessary to achieve full legal transfer of the assets for the benefit of the investors, such a transaction should not be regarded as "non qualified" if it refinances a value-adding real economy activity.

Therefore, consideration should be given to the incorporation of synthetic (SME) transactions, in particular, in this classification. Synthetic transactions can be structured in a simple, transparent way and, through their capital relief, can result in positive effects for the real economy.

Answer to the third question

Basically, we agree with the proposed principles for term ABS. However, what is crucial is how these principles are specified in detail. It is extremely important for the specification to be carried out in close cooperation with the industry in order to avoid unintended consequences. For instance, the self-liquidating requirement should not mean that balloon payments, which are typical for most auto loan financing contracts, would be excluded. Recent analyses by Moody's suggest that the credit performance of auto loans with a balloon payment was better than that of full amortisation contracts without a balloon payment. Furthermore, revolving master transactions should not be excluded either, provided that they meet the other high quality criteria.

Nature of assets: Given the function of asset backed commercial paper (ABCP) programmes as a means of refinancing corporates and the fact that the industry sector also creates assets which have performed very well during the crisis, trade and consumer receivables should also be mentioned in Article 128. Consequently, the principles in Box 3 should also reflect high quality ABCP transactions in which trade or consumer receivables are securitised in addition to the asset classes already listed in Clause 134 in Box 3.

Furthermore, the criteria for high quality securitisation positions arising in the context of ABCP programmes should be specified. For this purpose, different specifications are required (i) for the securitisation position held by the sponsor of the ABCP programme when granting the supporting liquidity facility and (ii) for the ABCP themselves held by investors.

Proposed criteria for high quality ABCP (see also TSI: "The potential development of a high quality securitisation market in the EU – Part 2 – ABCP"):

- No re-securitisation;
- No security arbitrage business;
- The ABCP programme is a multi-seller programme;
- The ABCP programme refinances real economy assets;
- The ABCP programme is fully supported;
- The ABCP programme complies with the CRR requirements;
- The key features of the ABCP programme are set out in an information memorandum (or where there is a public listing, in a prospectus).

Proposed criteria for high quality liquidity facilities:

- No re-securitisation;
- No security arbitrage business;
- Refinancing of real economy assets;
- The real economy originator continues to service the refinanced assets (as if they were not securitised);
- The liquidity facility is granted by the sponsor and not a third party;

- The liquidity facility is senior (ranking at least *pari passu* with the ABCP).

Asset performance history: Trade and consumer receivables have shown a remarkably robust performance during the crisis (see also TSI: "The potential development of a high quality securitisation market in the EU – Part 2 - ABCP"). Based on our business experience, small and medium-sized companies as originators in trade or consumer receivables securitisations in ABCP programmes often do not have the capabilities to provide historical loss data in excess of that which they already reported in the applicable audited financial statements. In the context of the proven performance of trade receivables, we believe that small and medium-sized companies should not be excluded from qualified securitisations through the setting of standards that can only be achieved by larger financial institutions with extensive resources. ABCP transactions can only continue to be a cost-efficient way of funding for the real economy (in particular for small and medium-sized companies) if the reporting and data requirement can be fulfilled by the real economy and not only by institutions.

Expectations of payments: Trade and consumer receivables should also be considered and mentioned. The obligors in trade receivables transactions are in most cases other corporates that are assessed by the originator through a prudent and market standard debtor management, which is by nature different to the credit assessment of financial institutions. At the same time, companies originating consumer receivables are in many cases professionally organised, use score systems and generate highly granular portfolios.

Among producing corporates, for example, longstanding relationships (in many cases, many years) are of greater importance and the activities of supplier and client are more interdependent, especially in the manufacturing and machinery sector. Furthermore, corporates in the production sector have a security attached to the receivable in the form of a reservation of title regarding the item which has been delivered. For loan receivables, this is not appropriate in every case (senior unsecured). Furthermore, in ABCP transactions the sponsor is required to assess the originator's credit and collection policy in a transaction as part of the transaction execution.

Current and self-liquidating: For the sake of clarification, mention should be made of the fact that ABCP transactions are also self-liquidating and have committed liquidity facilities additionally in place which ensure timely payment.

134: As mentioned above, trade and consumer receivables should also be mentioned in such a list of underlying assets.

140 and 141 Initial data and ongoing data: For ABCP, any loan-level data is not useful as a means of achieving greater transparency because the number of the underlying receivables is extremely high and fast revolving (see also TSI: "The potential development of a high quality securitisation market in the EU – Part 2 – ABCP"). In addition, the risk of "non-existence" or fraud regarding the assets is covered by the sponsor bank, which closely monitors the transaction and the originator.

143 Servicing and counterparties: In this context we would also like to underline the legitimate interest of corporates to maintain confidentiality regarding their financing operations. Usually, refinancing under an ABCP programme is not public with regard to the identity of the originator, seller and servicer. This is offset by the liquidity facility and the number of different originators (our proposal, a minimum of five for a high quality ABCP programme). On this basis, it is common market practice for the information regarding the originators, sellers and servicers involved to be treated confidentially.

Our experience has shown that a very high level of confidentiality is important for small and medium-sized companies (as well as for large companies) when we seek their consent to the true sale of their loans. Our experience has also shown this to be a very sensitive topic and we consider that confidentiality regarding the financial terms as well as the bank relationship is in the interest of the real economy. This also underlines and supports the positive acclaim for synthetic transactions for the securitisation of loan receivables.

Conversely, care must be taken to ensure that transactions that do not fulfil all criteria for "qualifying securitisation" are not automatically labelled as faulty or even dangerous and are punished even more. They may also be of high quality, albeit with slightly different characteristics.

6. Do respondents think that a liquid market for "qualifying" securitisations used for funding would result from a "qualifying certification"?

Yes, if also the planned regulatory conditions are not be exacerbated further. As impediments we see the planned revised provisions on the trading book (Fundamental Review on the Trading Book by the Basel Committee), the current draft of the Regulation on Money Market Funds and the new liquidity regulation which will probably limit the eligibility of all level 2B classes to 15% of the liquidity buffer. Moreover, eligibility as collateral under EMIR would support liquidity.

7. These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a "qualifying securitisation"? What are the associated risks?

<u>Answer to the first question</u>

Such a framework should contain a set of criteria that should discriminate between high quality and less high quality and should be evidenced as far as possible on the basis of the experiences of the last financial crisis. They should provide for a simple, transparent and robust securitisation market. The criteria themselves should be unambiguous, robust and clearly formulated to avoid legal uncertainty and facilitate implementation.

Moreover, consideration should be given to the fact that different regulations serve different purposes. Thus, it does not seem possible or desirable to fully define the same set of criteria for each regulation. The requirements for high liquid assets to be eligible as collateral for derivatives or as high quality for the trading book might differ from the capital requirements in the banking book, where liquidity is not important if the instrument is held to maturity. On the other hand, it would be desirable for the criteria to be standardised as far as possible in order to simplify the assessment of adherence to high quality criteria. This would make it easier for issuers to comply with different regulations. To increase the attractiveness of their issued asset backed securities, issuers will probably seek to comply with credit-related and liquidity-related high quality requirements which add to the number of requirements.

Thus, we propose a building blocks approach with a clear set of credit-quality-related criteria that have to be adhered to for credit products and a set of additional liquidity-related criteria that have to be adhered to for liquidity products. In any case, an important aspect to be avoided is that criteria referring to the same purpose are similar but not the same because different regulators have different opinions on their specification.

<u>Answer to the second question</u>

The framework should be developed in close cooperation with the market and especially with the already existing standard setters such as TSI, PCS and DSA.

<u>Answer to the third question</u>

All the needed regulation frameworks already exist on an EU level – of course not for financial products, but for all other products. The European Commission Directorate-General for Enterprise and Industry has set up regulations for almost every product. The assessment of safety and other preordained EU standards is done by “Notified Bodies”. In the European Union, these are organisations that have been accredited by a Member State to assess whether a product meets the regulation standards. Assessment can include inspection and examination of a product, its design and manufacture. A Notified Body within the meaning of the EU regulation is therefore an accredited private or public third party which is entitled by an accreditation body to provide verification and certification services. These services are intended to ensure and assess compliance with the previously defined standards and regulations as well as to provide an official certification mark or a declaration of conformity. In the case of HQS, the accreditation body could be the national supervisor or the ECB, the Notified Bodies could be TSI, PCS, DSA, auditing companies, etc. – which means all institutions which have a clear track record in assessing securitisation transactions. The associated risks are the same as for non-financial products but we see the process as having been satisfactorily tried and tested.

8. Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?

<u>Answer to the first question</u>

No. The level of harmonisation would seem sufficient for the time being. It is more important to observe the impact of the loan-level initiative of the ECB and the Bank of England. In addition, past experience of data harmonisation and software conversion has shown it to be expensive. In most cases the additional costs do not outweigh the benefits. If further data harmonisation between the Bank of England and the ECB has to be taken into account, not the maximum of both but the intersection should be selected.

With regard to ABCP, it has to be noted that the originators of the underlying receivables are real economy companies. Any obligation to provide loan by loan information in a strict form, for example, could cause additional costs or even prevent the company from being able to make use of an ABCP transaction as a funding alternative. Furthermore, there is a risk of such requirements disadvantaging, in particular, small and medium-sized companies with fewer resources and less sophisticated IT systems.

Answer to the second question

See the answer to the first question.

Answer to the third question

No need for the time being. See the answer to the first question.

9. Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?

Answer to the first question

We are not aware of any new initiatives in the area of standardisation of prospectuses and investor reports, but are of the opinion that the level of standardisation promoted by standard setters such as TSI or PCS is appropriate.

Answer to the second question

Standard setters for high quality securitisations such as TSI and PCS have done a great deal to enhance and standardise investor reports. It is important to strike the right balance between standardisation and flexibility in order to allow for the needs of market participants. Total standardisation of investor reports would also seem to be very difficult to achieve because of the heterogeneity and diversity of existing portfolios, local credit product differences in the EU and the broad variety of transaction structures. That is why TSI, for example, has only prepared specimen reports for each asset class and the final report is agreed by the originator and TSI in an iterative process in the course of TSI certification.

Nevertheless, to contribute to further improvement and standardisation as far as reasonable, the publication of best and sound practices on prospectuses based on analyses by the ECB or ESMA on a wide range of observed practices in the market could help to foster market discipline. In any case, further regulation should be avoided.

10. Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers ' confidentiality is preserved?

<u>Answer to the first question</u>

No. It is important to strike the right balance between the needs of originators and investors. Otherwise, originators will no longer be willing to securitise. Within the ECB's loan-level data project, in which all stakeholders were involved (originators, investors, the ECB, rating agencies, etc.), the required data sets were aligned. The loan-level data have to be provided for several months. We therefore do not see the need for further data. Further requirements could deter originators from issuance.

In addition, given the current broad discussions on data secrecy, further data bases and available granular client data on the internet might unsettle clients.

Answer to the second, third and fourth questions

No. Loan-level data to be provided in the ECB's loan-level data project were aligned with all stakeholders. Further data extensions do not seem appropriate for the time being. We propose waiting for the outcome of experience with the ECB's loan-level project.

11. In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

Answer to the first question

No. Such data should be selected and assessed by the investors. In addition, this could be an impediment for small and medium-sized originators which do not have an economic research department. In addition, it could promote herding behaviour if investors base their decisions on such information without carrying out their own assessments.

Answer to the second question

We think that the level of data provision is sufficient. First of all, the outcome of experiences with the loan-level data project, in which all stakeholders were involved, should be awaited instead of thinking about new requirements.

Answer to the third question

For the time being, in terms of market availability, the secondary market for ABS could be more transparent so as to reliably measure trading volume, which in turn is the basis for the construction of certain indices. On the basis of MiFID data, the EBA, for example, seemed unable to capture the whole ABS market when preparing its report on the definition of high liquid assets and therefore asked, via national banking authorities, some institutions to deliver its ISINs. As far as we are aware, it is not possible to identify asset backed securities as a class of securities within the MiFiD data. Thus, in order to assess the secondary market liquidity of the ABS market, we recommend urging ISO to extend under ISO 10962 the CFI codes that represent the kind of financial instrument and that usually have to be used when data on security trades have to be reported (MiFiD data). Alternatively, an EU classification of financial instruments could be developed that allows asset backed securities to be identified under the reported trades. In addition, we recommend differentiating between the ABS segments according to the classification used for the ECB's loan-level project.

Regarding ABCP, we would like to draw attention to the fact that due to the short-term nature of ABCP, there is no relevant secondary market. The absence of a secondary market does not indicate the illiquidity of ABCP but reflects the fact that short-term paper matures and is repaid before it can be sold.

12. Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

Answer to the first question

First, the liquidity of the second market should be promoted by stopping the impediments. Later on, this would be reasonable but will happen in any case if it is possible to construe meaningful indices.

Answer to the second question

Wrong signals if the secondary market is not sufficiently deep.

Answer to the third question

First, there is the need for a well-functioning secondary market.

13. Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

Yes.

14. How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

Answer to the first and second questions

See the answer to the third question.

Answer to the third question

The market for ancillary services is narrow. Besides the reasons outlined in Nos 119 and 120 of the discussion paper, account banks and/or swap providers fear the costs associated with a downgrade (such as transfer costs or costs associated with the collateralisation of counterparty risk). If an account bank's or swap provider's downgrade is caused by a systemic crisis, most probably no alternative counterparties will be available for the SPV. As a consequence, its securities will suffer a downgrade although the (credit) quality of the underlying portfolio will remain unaffected. In such a case, investors could be forced to reduce and sell their exposure, which in turn would deepen the crisis.

An initiative pursuant to which receivables of the SPV fall outside the institution's insolvency state would necessarily reduce or even eliminate the rating requirements currently established by the rating agencies if pre-insolvency scenarios, such as a moratorium, are also taken into account. This is not only true for account banks but to some degree also for swap providers since a privileged insolvency/moratorium treatment of claims associated with a swap agreement would substantially enhance the SPV's economic and legal position in an insolvency situation.

15. With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?

Yes, discrimination compared to covered bonds should be stopped (see answer to item 3, third question).

In addition, to avoid unintended consequences in terms of ABS structures with sound quality and cliff effects, we recommend developing a two-tier system that attenuates these impacts. At the top we recommend a set of criteria to qualify an ABS instrument as being of high quality and liquidity (liquidity product). The second class would require criteria for credit-related products to qualify as being of high credit quality.

16. Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

For the time being, we see no alternative.

17. Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?

<u>Answer to the first question</u>

Benefits in term of capital relief could also be achieved by synthetic securitisations if well designed.

Synthetic structures have been used in Germany with great success, not exclusively but in particular over the two KfW platforms PROMISE (SME) and PROVIDE (MBS). Problems relating to other synthetic structures have not occurred in the past because of synthetic structural elements but for other reasons, particularly resecuritisations, (actively managed) arbitrage transactions and structural leverage. The synthetic structuring approach was simply a means to an end. In the future, those kinds of transactions would be excluded by the corresponding high quality criteria and might be subjected to even worse treatment. Consideration should be given to distinguishing between "qualifying securitisation" as discussed above for the purpose of liquidity as well as high quality securitisation with slightly different characteristics for credit purposes supporting the also very important and helpful target of capital relief.

<u>Answer to the second question</u>

If well and robustly structured, risk can be held at a fairly low level.

18. Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?

<u>Answer to the first question</u>

In principle, yes. However, it is crucial how these principles are specified in detail. Thus, it is extremely important for the specification will be carried out in close cooperation with the industry so as to avoid unintended consequences.

<u>Answer to the second question</u>

That depends on the detailed specification. See the answer to item 5, third question.

TSI – What we do

High quality securitisation in Germany and TSI – the two belong together. True Sale International GmbH (TSI) was set up in 2004 as an initiative of the German securitisation industry with the aim of promoting the German securitisation market.

Over the past ten years TSI has strongly supported the development of the German securitisation market. Its concern has always been to give banks an opportunity to securitise loans under German law on the basis of a standardised procedure agreed with all market participants. Another objective is to establish a brand for German securitisation transactions which sets a high standard in terms of the exclusion of originate to distribute, alignment of interest, transparency and investor information. Finally, the goal is to create a platform for the German securitisation industry and its concerns and to bridge the gap with politics and industry.

Nowadays TSI Partners come from all areas of the German securitisation market – banks, consulting firms and service providers, law firms, rating agencies and business associations. They all have substantial expertise and experience in connection with the securitisation market and share a common interest in developing this market further. TSI Partners derive particular benefit from TSI's lobbying work and its PR activities.

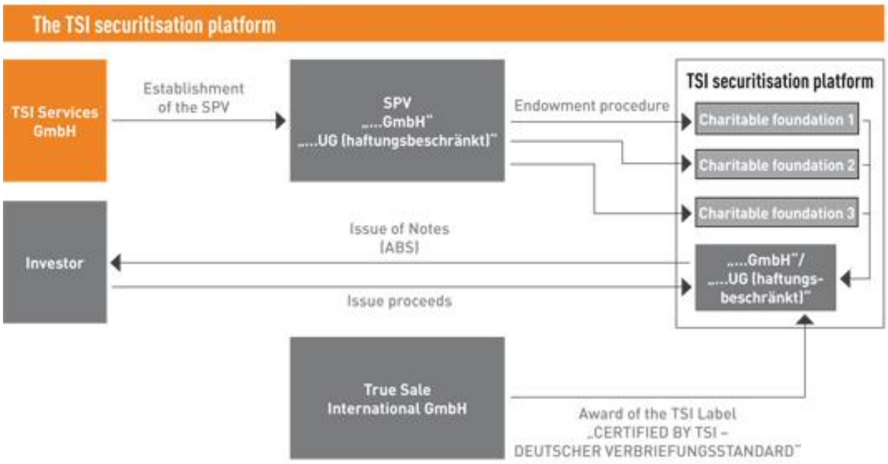
TSI securitisation platform

TSI has been providing special purpose vehicles (SPVs) under German law since 2005. In far more than 90 transactions, German and other originators have already taken advantage of German SPVs as part of the securitisation process.

The TSI securitisation platform comprises three non-profit foundations, which become shareholders in the SPVs set up by TSI. The non-profit foundations provide support for academic work in the following fields:

- Capital market research for Germany as a financial centre
- Capital market law for Germany as a financial centre
- Corporate finance for Germany as a financial centre

The three non-profit foundations are committed to promoting scholarship and science with a focus on capital market and corporate finance topics.



CERTIFIED BY TSI – DEUTSCHER VERBRIEFUNGSSTANDARD

DEUTSCHER VERBRIEFUNGSSTANDARD

The high quality of German securitisation transactions reflects the high quality of the standards applied to lending and loan processing.

The brand label DEUTSCHER VERBRIEFUNGSSTANDARD is founded on clearly defined rules for transparency, disclosure, lending and loan processing. Detailed guidelines and samples for investor reporting ensure high transparency for investors and the originator guarantees, by means of a declaration of undertaking, the application of clear rules for lending and loan processing as well as for sales and back office incentive systems. The offering circular, the declaration of undertaking and all investor reports are publicly available on the TSI website, thus ensuring free access to relevant information.

TSI events and the TSI Congress

TSI events provide opportunities for specialists in the fields of economics and politics to discuss current topics relating to the credit and securitisation markets. The TSI Congress in Berlin is the annual meeting place for securitisation experts and specialists from the credit and loan portfolio management, risk management, law, trade and treasury departments at banks, experts from law firms, auditing companies, rating agencies, service providers, consulting companies and investors from Germany and other countries. Many representatives of German business and politics and academics working in this field take advantage of the TSI Congress to exchange professional views and experience. As a venue, Berlin is at the pulse of German politics and encourages an exchange between the financial market and the world of politics.

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Response to the Bank of England and European Central Bank Discussion Paper: The case for a better functioning securitisation market in the European Union

TwentyFour welcomes the opportunity to respond to the discussion paper. We would like to thank the Bank of England and European Central Bank for producing a comprehensive, well thought-out and highly constructive document. We welcome the paper's in-depth review of the marketplace and particularly the intention to identify solutions for the reinvigoration of the market following the difficulties it has faced in recent years.

TwentyFour is a specialist, independent, fixed-income asset manager, based in London. Founded in 2008 by a group of highly experienced market participants with both sell-side and buy-side career histories, it now manages assets of almost £3.5bn. Our range of public funds includes three which specialise in European securitised assets at various levels of the capital structure from the most senior to very junior, alongside several broad credit funds which also invest in the sector to varying degrees and numerous segregated mandates which invest solely in various forms of Asset Backed Securities. Approximately 60% of our AUM is in Asset Backed Securities (ABS), and as such, TwentyFour are regarded as one of the leading RMBS/ABS managers in Europe.

TwentyFour is a member of the Association for Financial Markets in Europe (AFME) and was involved in helping to compile that organisation's response to the paper. As such we wholeheartedly endorse their response. TwentyFour is also a member of Prime Collateralised Securities (PCS), and was a member of the industry-wide working group that helped to create and design PCS, and in fact was the only investor firm amongst the founding members of PCS. Therefore, once again, we fully endorse the response from PCS to the discussion paper. Because of this it would be inefficient for us repeat the points that these organisations have made in their responses, however would like to make a small number of additional points in our own response.

General Points

We wholeheartedly agree with the high-level principles approach that the paper advocates, however we would urge the Central Banks to coordinate wherever possible with other relevant regulatory authorities to ensure that whatever principles are finally decided upon are applied consistently across all regulated industries. We are aware the EBA is conducting its own research for the European Commission, and also that EIOPA is still finalising its Solvency II regulations, and where possible securitisation regulation across these regulators should be consistent.

We would strongly reiterate the points made by other respondents about the certainty and timeliness of the categorisation of transactions when they issued in the market. Should "final" certification not be able to be granted at launch, it is imperative that some form of certainty can be relied on by investors, whether it be compliance with a "tick-box" approach or via proxy compliance through another private sector label (such as PCS).

Responses to some of the Specific Questions

1. *Do respondents agree with the benefits of a well-functioning securitisation market as outlined in section 2?*

   We would note that some of the target investor groups such as insurance companies and pension funds were not significant investors in securitisation markets prior to the financial crisis. There are a number of reasons for this, some of which are identified in the paper, but some which are not. Macro-economic conditions through the late 1990s and early 2000s meant that fixed-income markets experienced a long term bull market throughout this period. This, in turn with the longer term investment needs of these types of investors meant that they generally targeted longer dated, fixed rate securities. In fixed-income credit markets, many of these investors also targeted assets across the broad investment grade spectrum in order to benefit from the higher yields available. Due to the nature of the main ABS investor base at the time, deals were typically structured as shorter dated, floating rate securities, and because of the basic structure of ABS, the vast majority of notes issued were in the senior classes which were typically low yielding. This does not have to be the whole case going forward but will take time to change.

2. *Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?*

   For those investor groups mentioned above that were not previously significant investors in securitisation markets we would note that along with the obvious impediment of the negative stigma that is currently attached to securitisation, and which we encounter on a very regular basis, that should this be overcome, the prospective investors are likely to encounter a significant expertise shortfall. This could be overcome by recruiting experienced personnel or alternatively by outsourcing to specialist asset managers (such as TwentyFour). The recruitment option in particular is likely to be a time consuming exercise, and prove a major, if not insurmountable, barrier to entry for some. We would also note that many pension funds rely on advice from the investment consultant sector, so not only would some level of expertise be required within the funds themselves but also at the consultant level, which in our experience has not been a focus of many of these companies.

4. *Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?*

   Whilst low market liquidity is often quoted as an problem for securitisation markets, as a fixed-income credit markets asset manager active across the broad marketplace (including investment-grade corporates and financials, high yield etc.) we would note that liquidity is a problem across all of these markets – not just ABS. Reduced risk appetite from the dealer community as a result of the increased cost of capital (we would estimate that banks now offer between 10% and 20% of the amount of liquidity they did previously in an overall credit bond market that has grown by approximately 50%) is a significant driver of this.

   We would also note that throughout the massive deleveraging seen during the financial crisis, there was always a bid for ABS bonds, but prices were lower/spreads were wider. The real issue therefore was price volatility, and not actual liquidity. Today, as the market recovers, and ABS supply has been thin, the biggest difficulty is finding offers in bonds, especially as issuers have been discouraged from public issuance by the cheap funding that is available from central banks.

5. *The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?*

   If our interpretation of your question is correct, we would caution against any standardisation regulation being applied to "pay-offs" if this refers to the prepaying nature of many asset backed securities, although we do endorse reasonable levels of simplicity of structures where no more than relatively straightforward changes to the principal payment waterfalls should be allowed in 'qualifying securitisations'.

   We would endorse the point in paragraph 140 which states that cash flow models should be made available. We think that this is very important. Whilst it is unlikely that these cash flow models will be heavily used in the normal course of events, as most market participants rely on third party cash flow modelling providers which also allow various levels of assumption input and therefore stress testing, we believe that issuer cash flow model will be extremely important should deals come under any stress or in the event of a dispute, as they will represent the ultimate "source of truth".

7. *These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?*

   We would fully endorse the use of an organisation such as PCS to act as a certifying body, or alternatively were the regulating authorities to undertake the certification themselves for a label such as PCS to be able to act as a proxy indicator to investors until the full certification is applied.

8. *Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?*

   We would caution that further initiatives to publish more and more data may not add value, as in our view, there is already sufficient information provided for discerning investors to be able analyse deals and make informed investment decisions.

9. *Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?*

   We would welcome some further standardisation of investor reports where appropriate and a simplification of prospectuses, which have become overly large with frequent duplication.

13. *Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?*

   Certainly the ability to be able to compare assets on a more level playing field without the need to take sovereign and other operational issues into account would be very helpful.

16. *Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?*

    We heavily concur with the comments of AFME in their response to this question regarding the proposed ECB purchase programme – otherwise there is a significant danger that the purchase programme will have opposite effect from that intended and rather than revitalising the public securitisation markets would actually cause it to shrink significantly as issuers opt to issue only to the ECB.

Dear Sir or Madam,

Regarding your discussion Paper “The case for a better functioning securitization market in the European Union” we are answering to the following question:

Do respondents think that initiatives currently undertaken by authorities in the area of standardization of prospectuses and investor reports and trade transparency are sufficient or are the scope for further improvements? Would the availability of prospectuses and standardized investor reports in a single location be helpful to securitization markets?

Assuming that the initiative aims to support a better funding of the small and medium business in Europe, we are most probably talking about non-frequent issuers which are very often larger banks without professional or sufficient treasury and legal departments. These corporates struggle very often with quite simple problems doing their first ABS-Transaction. These problems are based on missing knowledge, manpower and also technical deficits, which are at least sometimes the final show stopper. Thus small and mid-sized corporates very often shy away doing the first ABS-deal and remain struggling in the credit-stared market.

If central bank really would help to support a better functionality of the securitization markets and provide a better funding to these market participants, they have to level off the market entering barriers by developing standardized prospectus and investor reports. This standardization could derive from existing best practice deal-structures and differ by asset class and local legislation. An additional limitation to true-sale-securitization with Backup-Servicer-Structure should give confidence to the market that these financial instruments are real refinancing tools for the economy and not toxic, simply risk transferring deals.

Doing this the central banks would give a “red line” to the small and mid-size corporates and something like a how-to-guide for securitization. Hence the central bank will give more confidence in ABS-Products to these corporates in combination with probably less development costs. IT provider and reporting agents like us will be able to provide standardized high quality services to the market, like European Data warehouse does for the loan-level-data. This is what TXS is interested in – providing a standard platform to small and mid-sized corporates . On this solution we are working together with SAP AG and their technical capabilities (SAP HANA: In Memory Technology for Big Data, SAP Financial Network: technical integration and payment processing between corporates and banks, SAP Funding Management: Securitization software for transaction structuring and processing). A standardization in the area from an business point of view together with SAP technology innovations as a market leader will probably improve the securitization market.

About us:
TXS GmbH is one of the leading provider of securitization services in Germany. Founded in 1996 to provide a software for the German regulated bond TXS grew up to the leading provider of covered bond software in Germany. 2005 TXS became an strategic Partner of SAP AG.
We are interested to help the market improving the securitization opportunities to small and medium-sized companies with our technical solutions and knowledge. So please do not hesitate to contact us for further discussions or Workshops.

Kind regards,

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UniCredit reply to the ECB and BoE consultation on "the case for a better functioning of the securitisation market in EU"

UniCredit is a major international financial institution with strong roots in 17 European countries, active in approximately 50 markets, with almost 8,000 branches and over 130,000 employees. UniCredit is among the top market players in Italy, Austria, Poland, CEE and Germany.

1. Introduction – A few highlights on UniCredit experience

UniCredit utilizes securitisation for multiple purposes:

- group funding and liquidity purposes;
- efficient funding of customer-driven transactions;
- direct investment in ABS securities and
- managing risk and capital consumption.

Whatever the underlying purpose, securitisation provides clear benefits for the real economy.
In fact, true sale securitisations represent an important source of funding for UniCredit (from 1999 to 2007 UniCredit realized 27 transactions for approximately €40 bn; since mid-2007 UniCredit issued 17 transactions for about €70 bn, most of which were retained). In addition, UniCredit actively promoted European market led initiatives such as the Prime Collateralised Securities (PCS) label and the ECB loan by loan template. These initiatives provide the foundation for maximum investor acceptance and, therefore, future market growth.
UniCredit expects the securitisation market to be more effective in contributing to the funding needs of the real economy, provided that relevant regulatory changes are introduced (e.g. revision of capital requirements for banks and investors; broadening of eligible securitized asset classes in the Liquidity Coverage Ratio).
UniCredit operates also through synthetic securitisations to optimize capital allocation both on existing/originated loans and on loans to be granted. For existing loans, synthetic securitisations provide a means of managing capital and risk in order to allow to optimize the capital absorption to be freed up for new loans. Synthetic securitisations on loans to be granted provide the further benefit to improve borrowing costs for new small and medium enterprise (SME) customers.

2. Main highlights

It is first of all important to acknowledge that with the exception of transactions that were highly structured or involving non-traditional assets, **securitisations performed generally in line with the overall credit markets following the 2007 financial crisis**. Non-standard securitisation proved more illiquid than standardized securitisation instruments which performed well. **Illiquidity** was mostly due to the fact that demand deteriorated massively as credit risk factors and counterparty risk surged, and forced sellers emerged.

On the other hand, currently market illiquidity stems mostly from the origination side. Demand is high but there is hardly any supply and assets for origination are scarce.

How can competent authorities help rebalancing the demand and supply mismatch? R**egulatory responses to the crisis have not effectively differentiated among securitisations** and therefore tend to

unnecessarily penalize certain types of securitisations, with negative consequences on the financing of the real economy.

The ECB / BoE consultation proposal, by opening the way to acknowledge qualifying securitisation, is definitely important and highly welcome.

UniCredit considers that "qualifying securitisation" would be those securitisations **meeting eligibility criteria set by central banks** as well as meeting **certain market standards that are a proxy for regulatory compliance** (e.g. PCS label compliant).

In UniCredit's view, "qualifying securitisation" should receive a **regulatory treatment more commensurate to the lower risk embedded**.

To achieve the objective of defining a qualifying securitisation, it seems highly **preferable that the certification for qualifying securitisation is granted by a non-profit independent and highly credible third party**, similarly to what happens with the PCS label.

UniCredit is of the view that **a different regulatory treatment for qualifying securitisations would contribute to properly address the current mismatch between demand and supply**, therefore **revitalize the securitisation market**.

3. Answers to specific questions

1. Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?

36/37. UniCredit agrees. Securitisation is a useful investment instrument in both liquid and illiquid markets. In fact liquidity is an important but not the key requirement for investors such as insurance companies and pension funds. Indeed, under the current market conditions, maturities of publicly placed ABS tend to be short to medium term in nature. This reflects the underlying assets, corresponding loan maturities and prepayment expectations. Nevertheless, maturities of securitisations can also be prolonged by structural features, e.g. via revolving pools or simply by selecting longer maturities of the underlying assets such as in securitisations involving household mortgages.

38. UniCredit agrees.

39. UniCredit agrees with the benefits of securitisation as a funding tool for banks, including the benefits of diversification and of the broadening of the investors' base.

40. Concerning the sentence: *"It is important to note that in order to take advantage of the securitisation market, non-banks will also require the expertise, information and technology to undertake direct lending in the first place.",* one might also refer to securitisation as a funding tool for non-banks, e.g. with respect to conduit financing of corporate trade receivables. Such funding structures are well established and the related expertise, information and technology represent a core business requirement for a range of corporations.

UniCredit agrees with paragraphs 41-44. As for 44, it is noted that securitisation is a useful risk transfer tool and could foster lending activities by banks to the SME sector.

45. There might also be structures involved for which a mixture of cash and synthetic securitisation techniques are used. Synthetic structures are not necessarily more complex. In fact, they are easier to install, involve lower cost and can be used for a relatively standardized risk transfer. Obviously, synthetic structures are not used for funding purposes but solely for risk and capital management.

46. UniCredit agrees. In addition, also strategic decisions at bank level can be a motivation to improve risk management.

No additional comment on 47 and 48.

49. Market liquidity is a function of demand and supply. For securitisations, demand and supply factors are manifold and largely depend on the underlying pools. **Demand**, to a high degree, is determined by price, WAL, yield/credit risk, credit enhancement, structural features, regulatory cost and qualitative issues such as deal-transparency, program history or counterparties involved (e.g. for servicing). **Supply** is very much determined by the asset side, funding needs of an originator and costs involved. Balance sheet considerations (offloading of credit risk, funding) of originators are key for supply, as also expressed in the consultation paper. During times of crisis (not just in the structured finance meltdown following 2007 events), **non-standard securitisation proved more illiquid than other standardized securitisation instruments** which performed well. **Illiquidity** in some types of securitized assets was mostly due to the fact that **demand deteriorated** massively as credit risk factors surged, counterparty risk surged, and forced sellers emerged. In other words, there were only offers, hardly any bid for paper.
Today, **market illiquidity stems mostly from the origination side**. **Demand is high, bids are manifold but there are hardly any offers and assets for origination are scarce.** On the demand side, the pricing is probably not remunerative for taking risks down in the capital structure (more junior tranches) particularly given the increasing capital cost attributed to such positions. For more standardized bonds, the imbalances between demand and supply proved lower during market turmoil. However, the nature of the instrument itself implies a higher market liquidity risk in times of market disruptions (be it related to a macroeconomic downturn, a housing market crash, a banking/originator specific problem, etc.) than it is the case for other credit instruments or asset classes which are either more standardized or much more exposed to idiosyncratic rather than systemic risk.

50. The differentiation into "*liquidity products*" and "*credit products*" seems to be appropriate. Albeit, from a risk analysis perspective, the phrase "*liquidity products*" might turn out to be delicate, given the fact that for example before the crisis many large money market funds (e.g. in France) invested in high quality senior securitisation tranches . The sharp reduction of this investor base following the crisis contributed to create huge illiquidity premia and mark-to-market write offs, causing severe problems for any money market fund investing in the relevant ABS. For all these reasons, a differentiation similar to financials or common bond indices into "senior, low-risk, high grade, main, standard" etc vs "mezzanines/sub, high risk, low grade, etc." would potentially be more appropriate.

2. Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?

UniCredit agrees with paragraphs 72-79, 81-82.

80. UniCredit agrees. However, in UniCredit view the worst in terms of rating adjustments and corrections has already happened and investors are now accustomed to the new rating framework.
As for the calls that may be exercised by the issuers, they are by definition voluntary and in most cases not exercised. Hence the call risk, of which investors need to be aware of, is a common feature and is comparable to the risks embedded in investing in subordinated bonds issued by -corporates and financial institutions.

Additional impediments: Other counterparty risks that could be considered: restructuring of banking groups in some of those countries which suffered most the financial crisis, servicing discontinuity, the risk of a concentration of only a small number of highly rated swap counterparties in the EU etc.

Regarding economic concerns of investors, it is mostly the economic environment that causes risk aversion down the capital structure or requires relatively high costs for a successful public placement. Presently the low interest rate scenario contributes to a lower deterioration of the assets originated in countries which suffered most the financial crisis. It remains uncertain what would happen if the interest environment changed.

Regarding regulatory hurdles, the complexity and heterogeneity of the various regulations and practices by competent authorities are confusing investors. A common and much simplified framework is definitely needed to create the conditions for a more liquid, easier to handle and more standardized high quality securitisation segment.

Against this background, from an investor's perspective, available credit opportunities to invest in ABS are rare in the aftermath of the financial crisis.

3. Do respondents agree with the impediments to and economic concerns of issuers that have been identified? Do respondents agree that the infrastructure concerns raised above affect the economics of securitisation? Do respondents think that there are any additional impediments to issuers, and if so, what are they?

83. UniCredit agrees. However, it is noted that risk retention rules per se are no longer a huge obstacle from an originator's viewpoint and contribute to the built up of bondholders' confidence. In addition, some uncertainty remains in terms of the proper implementation of the retention rules by the originator.

UniCredit agree with 84, 86 and 87

85. UniCredit agrees that a certain loan volume has to be reached albeit lack of granularity and niche markets are not necessarily an impediment to new issuance. The pooling of a smaller number of more exotic assets as well as less granular transactions also from niche assets is possible and has been accepted by the market in the past, also in the SME sector (e.g. mezzanine CLOs). **It is important to note that the sourcing of assets is definitely one of the key challenges helping to explain why there is little new issuance at present.**

88. UniCredit agrees. The availability of suitable IT systems and related expertise is a hurdle for smaller investors and definitely an entry barrier to arrange new transactions. Nevertheless, new and enhanced service providers and tools have been developed. As a result, system hurdles are significantly lower today than before the financial crisis.

89/90. UniCredit agrees. Credit rating agency interdependencies and re-adjustments have added complexity and uncertainty to both issuers and investors. More transparency from the CRAs would be needed on the "real" credit enhancement associated to the transaction regardless of the rating sovereign cap. Competent authorities should factor in the "real" credit enhancement in their regulatory assessment.

91. UniCredit agrees. The "counterparty conundrum" is a problem for new issuance, i.e. there are limited counterparties with top ratings available to offer swaps and other facilities. In addition, the costs for such services have risen.

92. UniCredit definitely agrees to the other considerations developed in this paragraph affecting costs.

4. Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

93./94. Nowadays **market illiquidity is mainly explained by the absence of supply rather than by the limited investor demand.** High demand versus limited offers has led to a significant spread compression and low trading volumes. Market illiquidity is only one of the variables affecting pricing. In fact there are idiosyncratic and systemic credit risks to be taken into account, as seen since 2007 .
As for the coupon features, there is an increasing number of fixed rate tranches in the market. Floating rate notes are expected to rise in the long-term with higher inflation and increasing interest rates. UniCredit agrees that buy and hold investors are currently the dominant investor segment and this has resulted in limited trading activity.

5. The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitisation' not

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already included in the principles in Box 3 should warrant such treatments? Do respondents have any comments on the principles in Box 3?

124. UniCredit agrees.

125. UniCredit does not agree that whole business securitisation performed poorly during the financial crisis. Whole business securitisation is a mixture of corporate and securitisation features. Risks are therefore more linked to corporate or project risks rather than merely to the pool of underlying assets.

Basically, the definitions listed in Box 3 are appropriate characteristics for high quality transaction features in relation to paragraph 100 mentioned in the consultation paper. The characteristics in Box 3 can be used to determine and define a "high quality securitisation" segment. In practice, it could turn out to be challenging to define asset pools compliant to numerous requirements, particularly in the SME asset class, across different jurisdictions and with different loan standards involved as expressed in paragraph 102. Quality guidelines such as the one by PCS in Europe (or TSI in Germany) might also be supportive in respect of defining a "qualifying securitisation".

6. Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?

Yes, UniCredit deems that a qualifying certification, based on certain eligibility criteria, is likely to be conducive to a more liquid market. UniCredit considers that it is of paramount importance that the PCS label is regarded as a "qualifying certification" from a best market practice perspective and therefore it is included in the set of the eligibility criteria for the regime foreseen by the legislator, the regulator and the central bank.

The principles underlying the PCS label are simplicity, transparency and standardisation. The fulfillment of the eligibility criteria for being granted the PCS label are designed to meet investors' needs and are therefore conducive to broaden and deepen the investor base. As such the PCS label is seen as a structural market feature creating the conditions for enhancing market liquidity in the securitisation segment.

7. These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?

Central banks, legislators, banking regulators, securities regulators and investors might have, understandably, different objectives when designing qualifying "securitisation".
For example, the PCS label is designed as a high quality securitisation to primarily meet investors' needs for best market practices, with a balancing act taking into account feasibility and issuers' constraints. PCS labelled securitisations are characterized by standardised criteria leading to more simplicity, transparency and quality. Quality is both in terms of the structuring process and in terms of well performing underlying asset classes (see table below for the comparison with the US).

European securitisation default rates: mid-2007 to end 2013		
	Orig.Issuance (€bn)	Def.Rate (%)
Total PCS eligible asset classes	960	0,15%
RMBS	756	0,12%
Total Non-PCS eligible asset classes	729	5,66%
Total European securitisation issuance	1,689	2,53%
Covered Bonds	1085	0%
Total European issuance	2774	1,54%
US RMBS	3255	22,05%
Source S&P, AFME		

Nevertheless, the regulatory treatment of securitisation in EU is problematic and under review. There is a concrete risk that the final rules (mainly calibrated on the poor performance of US ABS) will hamper the revitalisation of this market. The certification of qualifying securitisation could play a crucial role to avoid such occurrence.

What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'? What are the associated risks?

Who is more suitable to provide a certification on securitisation: a public or non-public entity? The answer is not straightforward. It depends on several aspects: the objective of the certification, the underlying financial instrument to be certified, the governance of the entity, the enforcement, the reputational risk and the certification process.

UniCredit has so far based its contribution to the PCS initiative based on the following assumptions:

Assumption 1 on the objective: PCS eligibility criteria, targeted to investors, need to be quite tight for allowing strategic asset allocation decisions in favor of certain securitisations and also enhance the ability of investors to perform their due diligence. This inter alia led to the exclusion of a number of asset classes and complex structures. It is noted that securitisation eligibility criteria for central banks do not need to be as tight, not only because of the different risk aversion and tolerance of the Eurosystem vs the investors, but also in order to ensure that a sufficient amount of collateral is available and properly distributed within each counterparty eligible for central bank credit operations.

Assumption 2 on the financial instrument. The securitisation technique implies that the financial instrument to be granted a certification is i) not simple and ii) subject to rapid market innovation. Hence it is easily and over time potentially subject to ill-designed calibration and arbitrage. Accordingly, the definition of the eligibility criteria requires an adequate degree of knowledge, competence and experience of the securitisation market.

Assumption 3 on the governance for the entity providing the certification. Having an efficient and effective governance is essential for whomever will be responsible for defining the criteria for the qualifying securitisations.
An efficient governance in the certification process requires the ability to change and correct the calibration of parameters, limits and eligibility criteria in a flexible and timely manner.
An effective governance implies at least a two-level review. The first level (e.g. PCS Market Committee) brings competence and experience of a diversified audience of issuers, arrangers and investors. The second and higher level (e.g. PCS Board) is the decision making body, supposed to bring credibility, independence, seniority and a strategic view in order to balance the input from experts, as there may be conflicts of interests.

Assumption 4 on the enforcement. In contrast with legislation and regulation which are binding at the same time to all the parties in the scope, and in contrast with the central bank eligibility criteria for securitisation which are by definition a sort of certification that will drive market standards, the application to the certificate is on a voluntary basis. Hence, the enforcement is potentially an obstacle since it requires that there is a value for investors so that issuers are incentivized to apply for the certificate.

Assumption 5 on the reputational risk. In view of the complexity of the instrument, there is an embedded reputational risk for authorities when defining too detailed parameters that may become rapidly obsolete or inadequate.

Assumption 6 on the certification process. Any labelling scheme needs to be cost efficient and capable to provide a certification at least at the time of pricing of each issuance, within a matter of days. This could be a challenge to be taken in due consideration in view of the complexity of the instrument and the amount of legal documentation of securitisation compared to other financial instruments.

Against this background, UniCredit deems that the certification (similarly to what happened to the PCS label) should be granted by a non-profit independent and highly credible third party (utility), which is accepted and valued by a broad range of investors.
Therefore we regard important that a regime is developed where authorities include the central bank eligibility criteria (for funding liquidity) and the PCS label as a proxy for regulatory compliance (for

market liquidity).

How might such a framework be developed?

An effective reference is the operational framework of the ECB and the STEP label. The ECB has a legal framework ("General Documentation of monetary policy instruments and procedures") where eligibility criteria are defined for the collateral to be put forward for Eurosystem credit operations. One criterion refers to the acceptable non-regulated markets[1]. Changes to this list do not require to update the legal framework. For example, one of the acceptable markets is the STEP market, which refers to "qualifying money market instruments", based on the STEP Market Convention, set by a not for profit non-public entity.

Along these lines, to achieve the objective of defining a qualifying securitisation, it seems highly preferable that the certification (similarly to what happened with the PCS label) is granted by a non-profit independent and highly credible third party (utility).
A institutional regime where competent authorities include central bank eligibility criteria (for funding liquidity) and the PCS label as a proxy for regulatory compliance (for market liquidity and other risks) is deemed appropriate.

With a view to employ a regulatory treatment more commensurate to the lower risk of qualifying securitisation, UniCredit suggests to legislators and regulators to define a set of principles and high-level requirements and then acknowledge that the central banks and the market may develop their eligibility criteria and market standards respectively. Competent authorities (i.e. EBA, EIOPA, ESMA and ECB) would then regularly assess whether those market standards adequately meet the pre-defined set of principles and high-level requirements. "Qualifying securitisation" will be the securitisations meeting those market standards and eligibility criteria.
In UniCredit view, the PCS label should be recognized among the criteria identifying "qualifying securitisations".

8. Do respondents think that harmonisation and further conversion software could bring benefits to securitisation markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?

UniCredit believes in the benefits of harmonisation and standardisation. However, at least for specific type of securitisation, current market standards have already improved significantly, including data availability by service providers such as Bloomberg, Intex, rating agencies, etc.

For a new SME high quality securitisation segment, data availability and harmonization could nevertheless still further improve. An hurdle to loan-level data is certainly the cost involved with assessing the data pool as well as the complexity of the data itself (data assessment and aggregation requires lot of time and capabilities). Performance indices as mentioned in paragraph 107 could be very useful to underline the high quality aspects of a "qualifying securitisation" segment.

9. Do respondents think that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements? Would the availability of prospectuses and standardised investor reports in a single location be helpful to securitisation markets?

The initiatives described in paragraph 108-110 are of great help. A single location would be preferable, if broadly accessible. Access to data related to OTC trades in the ABS universe would help to enhance transparency. A repository for investor reports and prospectuses, such as an evolution of the PCS market website, could be useful but should be considered against the cost of implementation..

10. Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets? Would credit registers be helpful in

[1] A list of these markets is provided on the ECB's website http://www.ecb.europa.eu/paym/coll/standards/marketable/html/index.en.html

this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?

UniCredit agrees that higher individual data availability would support the emergence of securitisation markets. However, the more complex and heterogeneous the data are, the less helpful the credit data access is. This could be the case for example of credit register data.

With reference to aggregated credit data, these could be useful and proved to be in several instances supportive, e.g. the portion of borrowers subject to insolvency, Fico scores or CCJ (country court judgments) data. It is challenging to compare credit data with different definitions, e.g. in terms of delinquency or default across jurisdictions, hence a certain degree of harmonization in this respect might be useful, particularly in the SME sector and across some countries which suffered most the financial crisis. Borrower confidentiality is key in this respect and if not warranted it could turn out to be counterproductive from a loan origination point of view.

All common asset classes should be considered in the scope of "qualifying securitisations".

11. In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardised data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

In UniCredit view, data availability has improved massively and is no longer the main cause for a muted secondary market. Secondary market functioning can be further supported by data availability but **the real cause for low activity is limited availability of assets from bank balance sheets for new transactions, i.e. limited supply of existing and new bonds**. Most investors have visibility to all important macro data - via research services and information providers such as Bloomberg. However standardized trading and credit data on a broader scope can be helpful to improve accessibility in particular to standardized WAL and prepayment rates, call date accessibility, call history, expected loss metrics, recoveries etc. Other data by banks, such as NPLs, could be considered as well. Expensive expertise (human resources) and modelling software such as Bloomberg or Intex could represent a challenge for market participants.

12. Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

116. With reference to paragraph 116, UniCredit would see active and consistent ABS indices as useful instruments. One has to distinguish between performance related indices on the one hand and price or spread indices on the other. The former indices, which are benchmarking credit risk, are already used by different rating agencies and can be produced relatively easy. The latter indices could support trading or allow for hedging etc. However, these indices are difficult to be created since transactions are not very standardized and, if there is not enough market acceptance, trading and index levels could be misleading. In the past, there have been a number of private efforts to create tradeable indices in Europe for specific securitisation asset classes like CMBS or RMBS (e.g. by Markit) but these efforts failed to become market standards. In general the lack of sufficient transactions makes it difficult to set-up tradeable indices, but this is nevertheless possible and desirable for a high quality standardized segment. Indices are particularly useful if consisting of a broad range of comparable instruments. Selected spread benchmark curves (non-tradeable but indicative) would also be useful as a comparable benchmark tool.

13. Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

Yes, this would be supportive from a transparency perspective, but since such implied rating information would not be as yet recognised in the Basel framework, its relevance is rather limited. It is also noted that rating agencies make available aggregated data which determine the rating distribution for a specific sector without sovereign ceilings being applied (rating distribution as if the sovereigns were rated AAA).

14. How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

123. In UniCredit's view, this is an impediment for the realization of the transactions at efficient costs, for example for Groups such as UniCredit that have a lower cost of funding in the unsecured markets.
Generally speaking, it is hard to assess the cost related to external facilitation of bank accounts. Basically any kind of risks related to a potential insolvency of the originator or a third party involved (set off, claw back etc) is always a key risk topic in securitisation, hence any initiatives, including a dedicated bankruptcy law for securitisation SPVs, to mitigate such risks are welcome. These risk elements, however, are typically addressed structurally and the methods by which these risks are addressed is generally reflected in the (i) ratings of transactions, (ii) the transaction costs (reducing the all-in cost for the Originator/Sponsor since a lower credit-enhancement would then be required) and (iii) the investor perception (since counterparty risk will be sterilized). Additionally, this would also have a positive impact for those Originators/Sponsors which are also deposit taking institutions, improving the liquidity management of the transaction. Given the rating migration, a number of Originators/Sponsors has suffered from a material liquidity impact, moving the SPVs bank accounts to third parties.

15. With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?

See reply to question 7, especially with the focus on the central banks' eligibility criteria and the PCS label. The capital treatment of securitisations for banks should be aligned with the intention of expanding the utilisation of securitisation as a mean for financing the real economy.

16. Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets?

See reply to question 7, especially with the focus on the central banks' eligibility criteria and the PCS label.

17. Beyond securitisation, might there be other ways of achieving (some of) the benefits of securitisation as outlined in Section 2? What might be the associated risks of such options?

Some benefits mentioned in section 2 might also be reached via alternative instruments which are closely related to securitisation. For example, covered bonds could play also a role in SME funding. Project bonds could play a growing role in infrastructure funding, at least in the some countries which suffered most the financial crisis, with project related benefits for the SME sector. These instruments could be both a funding tool to support real economy lending by banks and non-banks as well as investment instruments for banks and non-banks, insurance companies and pension funds, as outlined in section 2. Nevertheless, the costs related to such bonds appear to be relatively higher than for plain vanilla ABS and the investor base, particularly for SME covered bonds, is thin (only one comparable instrument was placed in the market, with core SME loans in the pool).

18. Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment? Are there any obvious unintended consequences?

The proposed principles, in line with the PCS eligibility criteria, are deemed sensible. See also reply to question 5.

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Please find below the list of the key contact-people involved in this work, whose contribution made possible to coordinate and provide UniCredit answers to this Consultation. Some other experts have been involved alongside the UniCredit Group, but are not listed below.

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Re: Response to the Discussion Paper: The case for a better functioning securitisation market in the European Union

The VDA Working Group on Auto-ABS welcomes the publication of the European Central Bank and Bank of England joint discussion paper, "The case for a better functioning securitisation market in Europe" (the "DP").

We are a coalition of the German automobile industry association (the Verband der Automobilindustrie (the "VDA")), the UK automobile industry association (the Society of Motor Manufacturers and Traders (the "SMMT")), the French automobile industry association (the Comité des Constructeurs Français d'Automobiles (the "CCFA")) representing the interests of the European automotive captive finance banks (the "Captives"), and the German Association of Autobanks (AKA).

The Captives are a major source of funding to the auto industry in Europe providing finance to dealers and consumers and facilitating the sale of vehicles across the EU. The Captives rely heavily on the securitisation of wholesale and retail auto loans and leases to fund themselves and their automotive parent companies.

We hope that the publication of the DP provides a clear signal to policy makers and regulators that the time has come to reconsider the regulatory approach towards securitisation in Europe, in particular towards high quality European securitisation which is amongst the best in the world and has performed consistently well even throughout the worst of the 2007/8 financial crisis.

Although we are starting to see positive signs of a change in direction, the regulatory framework for securitisation in Europe still poses many obstacles to recovery. In particular we are extremely concerned by the potential adverse capital treatment of securitisation under the proposed new Basle securitisation framework. When this is combined with the intended introduction of capital requirements for securitisation assets under Solvency II as well as the likely limited eligibility for securitisation assets under the LCR and the planned prohibition on money market funds investing in securitisations, the outlook is challenging.

We understand that the 2007/8 financial crisis was a banking crisis and that the many regulations that have been passed in Europe since then have been aimed at ensuring that banks are better run and better equipped to withstand the type of events that transpired when the US subprime mortgage bubble burst. Hence there are new global bank capital and liquidity requirements from the Basel Committee to be implemented in European regulations that don't consider the different performance of US and European ABS. Although these new rules have been predominantly aimed at improving bank strength regulators appear to allow, either by design or otherwise, for the very high quality European securitisation markets to be impaired in the regulatory process. These are markets that had nothing to do with the financial crisis which, as mentioned above, was directly linked to US subprime mortgages. It seems wrong to us that European legislators would design rules to negatively impact a form of financing that is essential to the health of the European economy and had no part in causing the financial crisis. Perhaps ironically, if we look to the US, it is evident that there is significant potential to develop a broad and deep European ABS market that would attract investors and assist in funding the real economy without jeopardising bank stability.

We thank the ECB and the Bank of England for their leadership and initiative as evidenced in the DP.

<u>Answers to selected questions from the DP</u>

1. Do respondents agree with the benefits of a well-functioning securitisation market as outlined in Section 2?

Yes, we agree. In particular, we would like to highlight the following benefits of a well-functioning securitisation market:

- To support and improve the financing of the real economy and thus to contribute to growth and employment in the EU by converting non-tradable financial assets into securities that can be issued to investors and traded on capital markets.
- To broaden the investor base, to diversify sources of funding and thus reduce the liquidity risks of originators while lowering funding costs and thus the financing costs for SME's, which in turn would contribute to stabilise the whole economy.
- To increase market liquidity, thus increasing the attractiveness of securitisation assets to investors and contributing to a robust market with prices appropriately reflecting risk. Increased liquidity would also allow better treatment of securitisation under regulations, e.g. under solvency II and the LCR which in turn would boost liquidity further and contribute to deepening the market (a "self-amplifying" effect).
- To support the diversification of investment portfolios and thus reduce systemic risks due to overreliance on a smaller set of available asset classes.

- To free capital by risk transfer enabling banks to finance SME's at reduced costs in the light of increased capital requirements and thus to enable SME's to participate indirectly by the benefits of the capital market.
- To decrease the vulnerability of originators to funding based on their own credit ratings (because securitisations have separate credit ratings independent from the rating of the originator).
- To facilitate un-encumbering originator balance sheets (something that is not possible with covered bonds, for instance).

2. a) Do respondents agree with the impediments to and economic concerns of investors that have been identified?

Yes, we agree. The main points that we would like to focus on are:

- The revised capital requirements proposed by the Basel Committee are too high – particularly for high quality securitisations with simple and robust structures such as European auto securitisations. Risks have been significantly overestimated and there is a consequent imbalance between capital requirements for securitised loans and non-securitised loans.
- Capital requirements under Solvency II are still too high for securitisation and insurance companies will be prevented from investing as a result. This applies even for high quality Type 1 securitisations. Furthermore, capital requirements for a high quality junior bond with, for example, credit quality step 2 and duration of three years will result in a capital requirement of nearly 50%. This level of capital charge will endanger the marketability of high quality ABS transactions because junior tranches are an integral and indispensable part of such transactions. Unfortunately, this point does not appear to have been sufficiently considered because, we believe, the political discussions focussed on "high quality" senior-tranches only and did not recognise that the creation of senior "triple A" tranches is not possible without strong junior tranches that need a market as well. We also believe that markets will be distorted due to the exemption for sovereign bonds.
- In relation to the standardisation relating of investor reporting a lot has already been achieved through the efforts of two well-known quality label initiatives, True Sale International ("TSI") and Prime Collateralised Securities ("PCS"). Moreover, the loan level data requirements of the ECB and the Bank of England provide standardisation and transparency of information and there are further reporting requirements proposed under CRA 3. The Captives are aware that some investors think that they are now being provided with too much information and that they would prefer aggregated rather than individual loan level data against which they could run more useful statistical analysis.

2. b) Do respondents think that there are any additional impediments to investors, and if so, what are they?

Yes. The main points are:

- Although we welcome Commission proposals to allow high quality securitisations to be included as level 2B assets under the LCR, the cap of 15% for all level 2B assets taken together is too low and will result in many level 2B assets meeting the eligibility criteria not being used for the LCR (due to the cap). Thus, this positive move from the Commission will have no practical positive effect on European securitisation markets.
- According to the draft of the Money Market Fund Regulation money market funds shall not be permitted to invest in ABS if the life of the underlying asset is more than 397 days, even if the securitisation will be eligible as a level 2B asset under the LCR and is of the highest quality. This does not appear to be reasonable or justified and will reduce the investor base and market liquidity of securitisation assets.
  New capital requirements proposed for securitisation positions under the Fundamental Review of the Trading Book by the Basel Committee will impede market liquidity.
- Covered bonds are receiving preferential regulatory treatment compared to comparable high quality securitisation which distorts the market. Examples are significantly higher capital requirements for high quality securitisation under the new proposed Basel securitisation framework and under Solvency II and the significantly less favourable treatment of securitisation under the LCR in terms of eligibility.

3. a) Do respondents agree with the impediments to and economic concerns of issuers that ave been identified?

We agree. If the higher capital charges proposed under the new Basle securitisation framework are not reduced it cannot be excluded that securitisation will cease to be a viable funding tool (because it will be too expensive for banks to invest in).

4. Do respondents agree that the infrastructure concerns raised bove affect the economics of securitisation?

The need to deliver loan level data in accordance with ECB eligibility requirements was expensive to implement and required considerable investment in reporting infrastructure. The merits of new data requirements should therefore be carefully weighed against their costs.

5. Do respondents think that there are any additional impediments to issuers, and if so, what are they?

The securitisation market in terms of underlying assets is a very transparent market. The provision of even more detailed information may deter originators from issuing securitisations. Moreover, more information does not mean necessarily better information. This applies, for instance, in terms information requirements as recently proposed by ESMA in its draft regulatory technical standard based on article 8b of CRA 3. Under article 8b, originators may be forced to disclose information that is confidential and/or commercially sensitive, particular with regard to competitors. Additionally, such information is not required because it is disclosed in the prospectus or in the case of private bilateral transactions, through the due diligence process.

We also note that there are discussions taking place between regulators about increased retention requirements which alienate issuers. We are convinced that the existing rules under article 405 CRR on the retained interest of issuers are suitable to strike the right balance for alignment of interests between investors and issuers. These rules should not be changed.

6. Do respondents agree that market liquidity may be a barrier to a well-functioning securitisation market?

Yes, at least for liquidity products. For pure credit products it might not be a barrier if the products are focused on buy-and-hold-investors or if the instruments have a short-term maturity.

7. The view of the Bank of England and the ECB is that a 'qualifying securitisation' should be defined as a security where risk and pay-offs can be consistently and predictably understood.

a) Do respondents agree with this definition?

Yes, we agree.

b) What characteristics of a 'qualifying securitisation' not already included in the principles in Box 3 should warrant such treatments?

Firstly, we would add the requirement of low concentration risk to ensure appropriate diversification.

Secondly, for the alignment of interests and to reduce operational risks we would recommend a prohibition on using third party servicers who have no "skin in the game" – in particular, we would recommend that at least the main services should be rendered by the originator.

c) Do respondents have any comments on the principles in Box 3?

Basically, we agree with the proposed principles for term securitisations. However, it is crucial that these principles are further specified in detail in close cooperation with the industry to avoid unintended consequences. For instance, the self-liquidating requirement should not mean that balloon payments, which are typical for most auto loan financing contracts, are excluded. Recent analysis undertaken by Moody's suggests that the credit performance of auto loans with balloon payments has been better than that of fully amortising products without a balloon payment. Further, revolving master transactions should not be excluded if they meet the other high quality criteria.

In addition, it should be made clear that transactions which do not fulfil all of the criteria for a "qualifying securitisation" will not be labelled as "junk". It has to be recognised that they may also be of high quality - just with slightly different characteristics.

8. Do respondents think that a liquid market for 'qualifying' securitisations used for funding would result from a 'qualifying certification'?

Yes, if regulatory conditions allow. We have discussed potential regulatory impediments at length above.

9. These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria.

a) How might such a framework be developed?

Such a framework should be based on a set of criteria that discriminates between high quality and less high quality securitisations. The criteria should provide for a simple, transparent and robust securitisation market. The criteria itself should be unambiguous, robust and clearly formulated to avoid legal uncertainty and facilitate implementation.

In addition, we recommend expressively excluding the products and business models that caused and contributed to the last financial crisis such as originate-to distribute models, re-securitisation, subprime segments and synthetic products related to an index.

We think that a building blocks approach with a clear set of credit criteria for credit products and a set of liquidity criteria for liquidity products would be the best approach. In any case, an important aspect to be avoided is that criteria referring to the same purpose are similar but not the same because different regulators (banking, insurance or security regulators) have different opinions on their specification.

b) What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitisation'?

There are two options:

1) A central authority like the ECB or ESMA could review each prospectus and related documents to certify that it is a "qualifying securitisation"; or,

2) Private certifying institutions such as TSI in Germany or PCS in UK could provide certifications.

In addition, we think that to give investors a clear indication and legal certainty as to whether securities are qualified or not, a central list should be compiled, continuously maintained and published that contains all qualified asset backed securities including issuance volumes.

c) What are the associated risks?

It is possible that the ECB or ESMA may experience a shortage of resources and may create a "bottleneck" slowing down the speed with which certifications may be granted. A private certifying institution also needs sufficient resources as well as a high level of expertise, sufficient experience of market practices, sufficient capabilities and a convincing reputation. We believe that both TSI and PCS would be capable to conduct such a certification process based on these requirements.

According to our knowledge of other regulated sectors, for instance, the EU Commission Enterprise and Industry has set up regulations for nearly every product. The assessment of safety and other preordained EU standards is done by so called "Notified Bodies". In the European Union, these are organisations that have been accredited by a Member State to assess whether a product meets the regulation standards. Assessment can include the inspection and examination of a product, its design and manufacture. A Notified Body in the sense of the EU regulation is therefore an accredited private or public third-party which is authorised by an accreditation body to provide verification and certification services. These services are meant to ensure and assess compliance to the previously defined standards and regulations, but also to provide an official certification mark or a declaration of conformity. In the case of high quality or qualifying securitisations the accreditation body could be the ECB or ESMA and the notified bodies could be PCS, TSI, or others such as auditing companies etc. The associated risks appear controllable.

10. a) Do respondents think that harmonisation and further conversionsoftware could bring benefits to securitisation markets? If so, which asset classes should be targeted? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors?

The current level of harmonisation appears to be sufficient for the time being. The same applies in our opinion with regard to the accessibility of existing loan level data.

We think that it is more important to observe the impact of the loan level initiatives of the ECB and Bank of England and weigh the benefits against the costs of data harmonisation and software conversion (which can be expensive). If a further data harmonisation between the Bank of England and the ECB is undertaken then only the most useful data with the highest information value from the perspective of investors should be selected. Moreover, such further harmonisation could only entail real benefits if it included harmonisation with the US loan level data requirements.

11. a) Do respondents think, that initiatives currently undertaken by authorities in the area of standardisation of prospectuses and investor reports and trade transparency are sufficient or is there scope for further improvements?

We are not aware on new initiatives in the area of standardisation of prospectus and investor reports, but are of the opinion that the level of standardisation promoted by TSI and PCS is appropriate.

b) Would the availability of prospectuses and standardised Investor reports in a single location be helpful to securitisation markets?

Quality labels such as TSI and PCS have done a lot to enhance and standardise investor reporting. It is important to strike the right balance between standardisation and flexibility to allow for the needs of market participants. Nevertheless, to contribute to further improvement and standardisation as far as reasonable, the publication of best and sound practices on prospectuses based on analyses by the ECB or ESMA on a wide range of observed practices in the market could contribute to foster market discipline. In any case, we think further regulation should be avoided.

12. a) Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitisation markets?

No. It is important to strike the right balance between the needs of originators and investors. Otherwise, originators may no longer be willing to securitise. Within the loan level data project of the ECB where many stakeholders were involved (originators, investors, ECB, rating agencies etc.) the required data sets were aligned. We do not see the need for further data. Further requirements could deter originators from issuance.

In addition given the current broad discussions in Europe regarding data secrecy the creation of further data bases holding granular client data may alarm European borrowers and infringe European data protection laws and principles.

b) Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?

No. We would propose that the effectiveness of the ECB loan level reporting requirements are analysed before any further initiatives are contemplated.

c) In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardised data?

No. The selection and assessment of such data should be driven by and instigated by investors. In addition, this measure could be an impediment for small and medium sized originators that do not have the capability to produce detailed industry data. In addition, it could also promote “herding” behaviour if investors base their decision on such information without making their own individual assessments.

d) What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome?

We think that the current level of data provision is sufficient.

e) What other elements would in your view help to improve secondary market functioning for high-quality securitisation?

We think that it may be helpful if the secondary market was more transparent thus facilitating more reliable measurement of trading volumes which in turn may form the basis for the construction of certain benchmark indices. Based on MiFID data the EBA, for example, did not appear to be able to accurately gauge the whole securitisation market when preparing its recent report for the European Commission on the definition of high quality liquid assets.

According to our knowledge, it is not possible to identify asset backed securities as a class of securities within the MiFID database. Thus, in order to better assess secondary market liquidity in the securitisation market, we recommend either: (i) asking ISO to extend under ISO 10962 the CFI codes that represent the relevant kind of financial instrument and that are usually used on securities trades that have to be reported under MiFID (MiFID-Data); or (ii) the development of a separate securitisation classification for financial instruments that will allow the identification of trades in asset backed securities so that they can be easily captured and reported. In addition, we recommend differentiating between securitisation segments according to the classification used for the loan level project of the ECB.

13. a) Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices?

Yes – but first the emphasis should be on improving the liquidity in secondary markets by removing other regulatory impediments. It is possible that indices may develop naturally in more liquid markets.

b) What risks might these give rise to?

Wrong signals, if the secondary market is not sufficiently deep.

c) What indices would be useful and which could be easily produced?

First, there is the need for a well-functioning secondary market.

14. Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary facilities rating caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

Yes, we agree.

15. a) How important do respondents see the impediment related to the availability of ancillary facilities? Would the benefits of facilitating SPV bank accounts that fall outside the originator's insolvency estate outweigh the costs of such an initiative? Are there other initiatives in this area that would be beneficial?

The market for ancillary services is rather narrow. In the event that an account bank or swap provider is downgraded due to a systemic crisis than it is likely that no alternative counterparties will be available for the SPV. As a consequence, its securities will suffer a downgrade although the (credit) quality of the underlying portfolio may be unaffected. Investors could in such a case be forced to reduce and sell their exposures which in turn may deepen the crisis (a pro-cyclical effect).

In our view, an initiative pursuant to which bank accounts belonging to the SPV fell outside the Account Bank's insolvency estate would reduce or even eliminate the requirements currently established by the rating agencies and would substantially enhance the SPV`s economic and legal position in an insolvency situation.

16. With regard to the policy options mentioned, are there any other considerations authorities should be mindful of?

Yes, we think that the adverse regulatory treatment of securitisation compared to covered bonds threatens to distort European capital markets and should be addressed as a priority.

In addition, to avoid unintended consequences and to attenuate cliff effects for ABS structures with sound credit quality, we recommend developing a tier two quality system. According to this approach, quality type I securitisation require a set of criteria to qualify securitisation instruments that are of high quality and liquidity. In addition, quality type II securitisation require only the criteria for high credit quality only products (i.e. less liquid products).

17. Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitisation markets? What might be the associated risks of such options?

See our proposal to question 16.

18. a) Do the principles set out in Box 3 seem broadly sensible given the objective of encouraging a set of securitisations that are more amenable to risk assessment?

In principle yes. However, it is crucial how these principles will be specified in detail. Thus, it is extremely important that the specification will be done in close cooperation with the industry to avoid unintended consequences.

b) Are there any obvious unintended consequences?

This depends on the detailed specification.

In closing, we wish to emphasise that the engagement of the Central Banks with market participants on the revival of the securitisation market in the European Union is appreciated. We are grateful for the opportunity to comment on the DP and we would be happy to answer any further questions that you may have.

Berlin, London, Paris – 04 July 2014

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Comments regarding the discussion paper: The case for a better functioning securitization market in the European Union (hereinafter referred to as "Discussion Paper")

Non-bank SME-securitization

This paper highlights the key benefits of non-bank SME-securitizations (hereinafter referred to as "NBS", for plural and singular) for the SME-sector and hence builds the case for a strong support of NBS by BoE and ECB.

Such support would be in line with the Discussion Paper. Quote: *"Well-functioning securitisation markets also enable non-bank financial institutions to raise funding for their real economy lending, thereby providing an alternative to bank lending."*

When generally referring to NBS we – for illustration purposes only – use the NBS, which has been initiated by WIR Finanzierer Group earlier this year. This NBS, which finances SMEs via the debt capital market, combines the greatest possible simplicity, transparency, and robustness a securitization could have.

NBS process: *About 25 SMEs, which comply with a defined set of rating requirements, individually issue a bond in amounts ranging between € 500k and € 10m (hereinafter referred to as "SME-Bond"). The SME-Bonds are exclusively purchased by an SPV. The purchase price is financed by the issuance of an investment-grade rated and listed capital markets bond, which is backed by the SME-Bond portfolio.*

Quote from the Discussion Paper: *"One natural complement to bank lending is the capital markets, which have played an increasingly important role in companies' access to finance post-crisis."* Via the NBS SMEs – for the first time – gain bank-independent access to the debt capital markets, from which they have been excluded so far due to high barriers to entry.

The following table compares the key characteristics and advantages of NBS versus the conventional, bank-based SME-Securitization:

<u>NBS approach</u>	**<u>Conventional bank-based approach</u>**
1. No adverse selection due to stringently applied, transparent and primarily rating-driven selection criteria;	1. Concerns about a potential adverse selection and the challenges of the incentive structure imbedded in the "originate to distribute" model triggered retention rules, which make securitizations less attractive to banks;

2. The absence of capital constraints results in an Impact Ratio of 1:1 (every Euro raised from the debt capital markets will directly fund SMEs);	2.1. Relatively high cost of capital for mandatorily retained exposure (“skin in the game”) questions the economic viability of securitizations; 2.2. Given that banks are largely still under pressure to deleverage, it is reasonable to expect that additionally gained lending capacity (e.g. via securitization) will not fully be used to grant new loans to the SME-sector; 2.3. Banks’ lending decisions are multi-facetted and clearly go beyond the mere lending capacity. The fact that borrowing requests get turned down also due to industry or regional concentration limits evidences that SMEs’ greatest hurdle remains, i.e. to get a bank loan in the first place;
3. Benefits open to all SMEs, regardless of existing, predominantly local bank relationships;	3. Since only a smaller number of regularly bigger banks (which generally lend less to SMEs) make use of securitizations, potential benefits will be limited to those SMEs, which maintain a business relationship with such bank;
4. Transparent bottom-up rating approach; rating reports on each SME-Bond as well as on the portfolio are available to investors (full transparency);	4. Transparency frequently restricted to a portfolio-based reporting format with limited or no transparency about the underlying assets;
5. No tranching of the debt capital markets transaction, which aligns the interests of all investors and hence leads to the highest possible degree of simplicity, transparency and robustness of the transaction (also no ancillary facilities and no hedging)	5. Tranching makes securitizations complex and opaque, which is why they conceptually fail to align investors’ interests. The inherent information disparity between banks and investors is likely to reinforce this misalignment;
6. Real-money transaction, which attracts new long-term investors, such as insurance companies and pension funds to invest into the SME-sector (funding assets);	6. Predominantly synthetic, regulatory arbitrage transactions, which do not attract a larger investor base (transferring risk);
7. Solid credit assessment of each underlying SME-Bond based on ratings from (i) the largest lender (local expertise), (ii) Deutsche Bundesbank (internationally recognized)[1], and (iii) Euler Hermes Rating as accredited rating agency (independent assessment); cumulative rating filter leads to high quality selection;	7. Rating filter applied to underlying assets is generally limited to the individual bank’s credit assessment;

[1] The Deutsche Bundesbank operates its own credit assessment system to assess the credit standing of debtors of non-marketable assets. Counterparties can use this to determine the eligibility of enterprises and debtors. Non-financial enterprises may have themselves assessed under this system, after which they receive a detailed financial analysis in the form of a fact sheet.

8. The servicing of the SME-Bond portfolio will be performed by professionals, each covering only about 15 issuers. In case of a deteriorating credit quality of individual SME-Bond issuers additional coverage resources come into play in the form of a recovery manager. This is being supplemented by the ongoing and timely monitoring performed by Euler Hermes Rating;	8. Coverage ratios of banks lending to the SME-sector are generally less favorable;
9. 100% disbursement of cash-flows generated from the underlying SME-Bond portfolio to the investors (no fees being charged to investors), which again evidences the simplicity and transparency of the transaction, the preconditions for an efficient market;	9. Greater complexity leads to a high costs;
10. 100% maturity match, since start date and the final maturity date of the SME-Bonds and the capital markets bond issue are in sync (no warehousing/build-up phase)	10. In part reliant on "unstable" short-term funding sources, i.e. no maturity match;

Recommendation:

Since NBS, as described above, have a couple of characteristics which make them superior to conventional bank-based securitizations we recommend that NBS benefit from at least the same level of support by BoE and ECB as securitizations initiated by banks, while taking into account the early stage of some NBS' business cycles.

Extending this support to NBS, as described above, will send the following strong signals to the market:

(i) BoE and ECB do support SMEs opposed to protecting the banks' lending business.

(ii) BoE and ECB are enablers of SMEs' broader, bank-independent access to finance. Providing SMEs with access to the debt capital markets will (a) unlock additional macro-economic growth potential and (b) make the overall SME-sector less vulnerable to market-disruptions.

Based on the advantages discussed in this paper we trust that we will jointly be discussing BoE's and ECB's level of support with respect to NBS shortly.

Yours sincerely,
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RE: "THE CASE FOR A BETTER FUNCTIONING SECURITIZATION MARKET IN THE EUROPEAN UNION"

The Working Group of the IIF's Council for Asset and Investment Management (CAIM) is pleased to have the opportunity to comment on the referenced discussion paper, and commends this very substantive effort towards enhancing the functioning of the European securitization market. The Council offers perspectives from its membership, currently over 30 long-term investors including life insurance companies, pension funds, sovereign wealth funds and asset managers, collectively accounting for some USD 20 trillion in assets under management.

Securitization plays a critical role in the provision of financing to consumers and businesses—including the vitally important SME sector. Against the backdrop of weaker activity in European securitization markets in recent years, which has economic, market and regulatory-related drivers, both public- and private-sector initiatives can help in supporting a broad-based revival. Securitization is an essential tool that can help achieve different objectives for different groups of market participants:

- For **originators**, including banks and other owners of underlying assets, securitization is a key means of funding as well as a valuable mechanism for diversifying both risks and the funding base. Securitization can also help free up balance sheets, thereby mobilizing credit for the economy more broadly.
- For the **corporate sector** specifically, including SMEs, securitization can reduce liquidity and funding gaps[1], lower financing costs and diversify the capital structure. For both banks and the corporate sector, securitization can help make the quality of the asset-backed security (ABS) independent of the creditworthiness of the originator. Securitization can thereby help achieve access to funding markets and sources that would otherwise be inaccessible.

[1] Bain & Co and IIF," Restoring Financing and Growth to Europe's SMEs.

- For **nonbank investors** including institutional asset managers, insurance companies and pension funds, securitization increases the opportunity set of available investments, providing significant potential benefits in terms of diversification and risk-adjusted returns. Tradable, liquid securitized debt permits investors to tailor and quickly adjust exposure to credit assets. Securitization gives investors the opportunity to gain exposure to real economy—in many cases to low risk, pooled assets that are normally within the domain of traditional banking.

While the Council welcomes all initiatives that will facilitate a much-needed revival of healthy securitization markets, including those targeted at other sectors, the following comments reflect perspectives of institutional investors.

GENERAL COMMENTS: NEEDS AND REQUIREMENTS OF INVESTORS

To be active in securitization markets, investors will look for appropriate risk-adjusted returns, sufficient market liquidity, sound structuring, and full disclosure of all risks transferred. The following high-level comments reflect the Council's broad views on these and other general requirements

1. A key requirement is sufficient **market liquidity and depth** across the maturity spectrum to both address the demands of both buy-and-hold investors and encourage participation of investors with shorter investment horizons for liquidity purposes (e.g. institutional mandates with higher turnover or hedge funds). In the current regulatory environment, risk managers at institutional asset managers may lean towards limiting or excluding investments in illiquid assets, whether or not they currently face specific regulatory constraints (e.g. the liquidity restrictions in Article 19 of the UCITS Directive governing Eurozone retail portfolios (SICAV)).
2. A **strong set of prudent underwriting and servicing standards** is a fundamental requirement for investors—and will also help address remaining reputational concerns. The adoption of such standards by originators, sponsors, underwriters and distributors would facilitate the due diligence process. To help improve the underwriting process, securitization structures should be simple and clearly presented, sufficiently collateralized, and have high-quality underlying receivables. The underlying pool of receivables should be dedicated to the securitization (no cross-collateralization) and the pool of loans should have low refinancing risk. Initiative such as PCS (prime collateralized securities), which aims to create a quality label for securitizations, are a welcome step in the right direction.
3. The underwriter can also signal prudent due diligence to investors by **retaining the credit risk of junior tranches**. Currently AIFMD requires European managers of alternative investment funds to ensure that securitizations they invest in meet the 5% retention limit.

4. To improve **transparency**, asset and transaction data should be readily available, with relevant updates disclosed in a timely manner. **Regulatory requirements**, data, documentation and prospectuses should be **harmonized across jurisdictions** to reduce the costs of in-house analysis and ratings.

5. The **regulatory framework** should be comprehensive, avoid inconsistencies, and protect investor rights (vis-à-vis, e.g., the originator, the SPV, or the ultimate obligor for underlying receivables, in addition to general creditor rights). Areas of regulation that affect or may affect institutional investors include: AIFMD (guidelines on credit risk of securitizations); CRD4 (guidelines on loan-to-value of underlying loans in RMBS, which could restrict investor choice); Solvency 2 (capital charges on securitizations for insurers); MMF regulations (limits their investment in asset-backed commercial paper); and an increased focus on regulation of “shadow banking” (potentially broad implications including on repo of ABS and investment appetite of MMFs).

COMMENTS ON SPECIFIC QUESTIONS

Q1: Do respondents agree with the benefits of a well-functioning securitization market as outlined in Section 2?

CAIM members broadly agree with the benefits of securitization summarized in the discussion paper. Points of emphasis and additional views include:

- Securitization expands the set of investment options for asset managers—a valuable source of diversification and risk management tool.
- Well-functioning securitization markets require not only liquidity and issuance, but depth in all key maturities to satisfy the demand of long-term buy-and hold investors, while leaving sufficient float for shorter term participants/dealers.

Q2: Do respondents agree with the impediments to and economic concerns of investors that have been identified? Do respondents think that there are any additional impediments to investors, and if so, what are they?

Respondents agreed with many of the impediments and concerns identified in the discussion paper. Points that we would highlight include:

- Many CAIM members note that a particularly limiting impediment for investors is the potential level of capital charges for holding securitization investments, relative to the risk of these investments. For example, the currently proposed capital charges under Solvency II would provide incentives for insurance companies to invest in assets that offer comparable risks, but carry much lower capital charges (e.g. covered bonds or whole loans). Capital charges at the proposed levels would reduce the global competitiveness of European investors, as regulatory capital regimes in other large markets like the U.S. provide for substantially more manageable charges
- Respondents underscored the importance of a supportive, coherent regulatory regime for securitization. The regulatory framework should avoid disincentives for securitization, with capital charges appropriate for the level of risk incurred (taking historical losses into consideration) and consistent across asset classes.

Q4 Do respondents agree that market liquidity may be a barrier to a well-functioning securitization market?

Lack of market liquidity can be a barrier to reviving securitization markets; however, the need for sufficient market liquidity is common to all well-functioning markets.

- Given the inherent challenges in measuring liquidity, a range of metrics including bid-ask spreads could be considered in addition to trading volumes. Assessment of liquidity should take into account that investors have varying mandates and will therefore have different needs for liquidity—some will trade more frequently than others.

Q5 The view of the Bank of England and the ECB is that a 'qualifying securitization' should be defined as a security where risk and pay-offs can be consistently and predictably understood. Do respondents agree with this definition? What characteristics of a 'qualifying securitization' not already included in the principles in Box 3 should warrant such treatments?

Do respondents have any comments on the principles in Box 3?

- CAIM working group members generally agree with the principles of simplicity, structural robustness, and transparency proposed for securitized products—all these should help investors consistently and predictably understand risks and payoffs. This is a key consideration for fiduciaries.
- Sound governance of the securitization vehicle, with adequate checks and balances present so as not to disadvantage any party to the transaction, is also an important principle.
- While most respondents agreed with the definition of "qualifying securitization," some noted that the term "simpler" seemed too vague, and inappropriate in the context of securitization. A potential replacement could be "not over-engineered."
- Similarly, some noted that the definition of qualifying securitization should be broad enough to encompass a range of sectors (to accommodate investor preference on type of securitization) and encourage innovation (e.g. of newer types of securitized assets such as trade finance receivables).

Q6 Do respondents think that a liquid market for 'qualifying' securitizations used for funding would result from a 'qualifying certification'?

- Qualifying certifications could result in the development of a more homogenous market segment, which could enhance liquidity.
- The certification process for qualifying criteria could increase investor confidence. Particularly if coupled with regulatory relief for qualifying securitizations, more market participants could migrate towards certified securities, which would result in greater market liquidity.
- Some CAIM members observed that independent certification prior to or at closing would be a strong positive, and suggested that augmenting the qualifying securitization definition with additional "modules for specific purposes" could be helpful.
- Such modules, or more granular categories of certification, could permit a more accurate representation of the risks inherent in some securitization sub-classes. This

would permit a more precise calibration of capital/liquidity and regulatory requirements, which in turn would aid investor appetite and improve liquidity.

Q7 These principles may then provide a framework to aid various authorities and market participants to set their own eligibility criteria. How might such a framework be developed? What role could the appropriate authorities play in the process of certifying that a transaction is a 'qualifying securitization'? What are the associated risks?

- A framework for setting eligibility criteria should have a homogenous methodology. One alternative to explore could be leveraging the broad industry efforts developed around the PCS label, although some members note that this label is currently restrictive and may limit the development of certain key sectors.
- Some respondents observed that Investors need to have confidence that once a certification is awarded, it will not be taken away--leaving investors in a situation where they need to hold additional capital or quickly dispose of a non-qualifying asset, perhaps on unfavorable terms.
- The process for obtaining a qualifying certification should be timely, straightforward and cost-effective for issuers (a complex, costly or protracted process could discourage issuers from obtaining the certification).
- The risk of moral hazard should be considered—in this case, that the authority or market participant in question could become a de facto credit rating agency or credit guarantee/enhancement issuer.

Q8 Do respondents think that harmonization and further conversion software could bring benefits to securitization markets? If so, which asset classes should be targeted? How can accessibility to the existing loan level data be improved, so that it provides most value to investors.

- Some CAIM member firms expressed agreement with the principle of standardization of documents, structures and investor reporting wherever this can be achieved (without unduly limiting flexibility in structuring). Fields common to virtually all transactions (e.g. in investor reports) could benefit from a degree of standardization. However, full standardization is unlikely to be workable.
- A central repository for investor reports could facilitate access to information—a material benefit for investors and one which could reduce barriers to entry for new players and smaller investors. Accessible, user-friendly software would be helpful.

Q10 Do respondents agree that facilitating investors' access to credit data in an appropriate manner could support the emergence of securitization markets?

Would credit registers be helpful in this respect? If so, which asset classes should be targeted? In what form could access be granted to ensure that borrowers' confidentiality is preserved?

- Respondents broadly agreed—with some discussion of what would constitute an appropriate manner—that facilitating investors' access to credit data would support greater activity in securitization markets. Some respondents expressed strong support for availability of data on underlying assets, noting that it would facilitate credit decisions.
- Access to information that enhances transparency may be helpful in bringing a broader range of participants, including smaller investors, into the market. Provision of more detailed information on the underlying loans in some types of securitizations, particularly more complex structures, could be beneficial (though some CAIM member firms cautioned that the goal should not be to "re-underwrite" the entire pool).
- More generally, facilitating investors' access to credit data and making data on underlying loans more transparent should help reduce borrowing costs.
- A number of members noted that credit registers permitting originators to supply more information about pools of securitized assets would be helpful. Such credit registers should use the same definitions across borders, harmonized with those used in the ECB Data Warehouse.

Q11 In order to aid performance measurement and to provide investors with industry-level data, would it be helpful if certain macro-economic data were disclosed or if banks/ non-banks published certain aggregated standardized data? What are the challenges of providing potential investors with sufficient borrower and loan-level data to enable them to model credit risk, and how can these be overcome? What other elements would in your view help to improve secondary market functioning for high-quality securitization?

- All else being equal, the easier it is for investors to assess risk and return characteristics of these instruments, the greater will be their participation in this market. Standardization of data, documentation and prospectuses will help in reviving the securitization market in Europe.
- Some respondents noted that the challenges of loan-level data provision are in the process of being addressed via the European Data Warehouse

- Some CAIM member firms believe it would be helpful to make the data underlying credit ratings decisions available to investors, giving them more insight in to the rating agency's methodology.

Q12 Do respondents think that authorities should consider encouraging the industry to develop such benchmark indices? What risks might these give rise to? What indices would be useful and which could be easily produced?

- Benchmark indices would be helpful in developing the asset class, particularly investable, simple benchmarks with widely available data.
- The private sector should be encouraged to develop such benchmarks: dialogue between authorities and private index providers would help facilitate the development of benchmarks across the maturity and rating spectrum.

Q13 Do respondents agree that additional information in the form of a matrix showing implied ratings if the sovereign and ancillary ratings caps were to be set at higher levels would be helpful in supporting the investment process and contribute to increased transparency and liquidity?

- Some CAIM members suggest that it would be helpful to have post-closing rating actions disclose the combined impact of sovereign / counterparty rating caps applied to a credit rating so that the underlying credit can be separated from the ratings impact of associated links.

Q16 Do respondents think there are other policy options authorities should consider to support the emergence of simple, transparent and robust securitization markets?

- Further development of specific categories of securitized products, such as securitized infrastructure bonds, could aid in developing a robust securitization market.