RESPONSE TO THE BCBS/IOSCO
Consultation Paper

12th February 2015

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INTRODUCTION

Prime Collateralised Securities ("PCS") would like to thank both the Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions for the opportunity to address the issues raised in their consultative document: "Criteria for identifying simple, transparent and comparable securitisations" published last December (the "Consultation"). PCS especially welcomes the Consultation as placing on the global agenda the issue of reviving a strong securitisation market able to channel global capital flows towards the real economy without attendant systemic risks. We note work of a similar nature is taking place in Europe and believe that it would be enormously beneficial, for reasons of global comity and consistency, if the European work were to dovetail into a consistent global approach. We see the Consultation as a positive starting point for weaving such a global approach to securitisation.

PCS is an independent, not for profit initiative set up by the securitisation industry, including originators, arrangers, investors and service providers. It was set up with the aim of assisting in the return of a strong and robust European securitisation market. This it seeks to do through the granting of a quality label and the definition (through its labeling criteria) of best standards including simplicity, structural strength and transparency[1]. Although its current remit focuses on Europe, PCS understands that a European securitisation market that nestles seamlessly into a global securitisation market would provide greater access for European real economy participants to global capital market funds. As such it has always sought to be engaged in the debates on securitisation at a global level.

[1] More information on PCS may be found at: www.pcsmarket.org.

GENERAL CONSIDERATIONS

Two stage approach

As a general matter, PCS is very supportive of the approach emerging from the Consultation in identifying simple, transparent and comparable securitisations ("STC securitisations"). As we understand it, this approach seeks to " unbundle" the pure credit risk arising from the assets from the structural elements that may weaken a transaction's credit quality. This "two stage" approach is consistent with proposals from the Bank of England, the European Central Bank[2] and the European Banking Authority[3] outlined in a number of recent publications. In our response to these publications, PCS was, at a conceptual level, in strong agreement with this approach.[4] To a large extent, many of our points in this paper will echo those that we made in our responses to these earlier proposals.

As we have outlined in those earlier responses, the factors hindering STC securitisations are the same as those affecting what PCS has called in the past the "structural integrity" of securitisations. In the hierarchy of credit analysis, structural integrity precedes the analysis of the core underlying credit risk of the assets (both logically and temporally). This is because the connection between these factors and poor performance in not a mere empirically deduced fact. It results from the impact these factors are bound to have on the capacity to perform a robust credit analysis.

In our view, the presence of one or more of these factors, directly and negatively impacts the capacity to perform a reliable credit analysis. In other words, the capacity of investors and/or regulators to derive a high degree of confidence in the second step of the overall credit analysis, namely the analysis of the credit risk of the underlying assets, is always eroded by the presence of one of these factors.

Predictability and securitisations

PCS believes that structural integrity is what the proposed STC rules are seeking to establish. For us, a securitisation with structural integrity is not necessarily a good credit but a predictable one, capable of robust analysis.

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

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[2]www.bankofengland.co.uk/publications/Documents/news/2014/paper300514.pdf
[3]www.eba.europa.eu/documents/10180/846157/EBA-DP-2014-02+Discussion+Paper+on+simple+standard+and+transparent+securitisations.pd
[4]http://pcsmarket.org/wp-content/uploads/2014/07/PCS-Response-to-BoE-ECB-consultation.pdf) and http://pcsmarket.org/wp-content/uploads/publications/5eebc/FINAL_PCS_EBA_response_14-01-15.pdf.

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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 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.[5] It therefore further follows that an approach seeking to define STC securitisations as those where risk and pay-offs can be consistently and predictably understood is an appropriate response to the crisis and a move towards reducing global systemic risk. An attempt that merely sought to define STC 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 an approach had been adopted in 2006, the outcome would have been any different from what actually came to pass. In this respect, we are indebted to the excellent analysis and formulation of these points as they appear in the joint Bank of England and ECB paper.

We therefore strongly agree with the contention made in the Consultation that "[d]ifficulty in assessing risk has been identified as an important impediment to sustainable securitisation markets" and agree that the purpose of a definition of STC securitisation should be to overcome this obstacle.

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 STC 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 four distinct elements (or, in some cases, more than one of those elements). Conversely, securitisations that did not contain any of these

[5] The 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.

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) 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).

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(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)[6]. 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.[7] 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 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.

It follows from this analysis that the presence of any of these four elements in a transaction will reduce any investor or regulator's capacity to perform a solid and safe credit analysis. This does not mean, of course, that no analysis can be performed. Nor do we wish to imply that the problems with confidence levels in credit analysis are equally deep for all securitisations that contain one or more of these elements. However, when seeking a definition of simple, transparent and comparable securitisations, history seems to indicate that these elements need to form the core of such work.

It also does not follow from our analysis that only these four elements should be part of a definition of STC securitisations. Merely because an element of structural integrity was not rendered apparent by specific failures in the 2007/2008 crisis, does not mean we should therefore jettison it. We must not become slaves to historical data at the cost of common sense and traditional credit analysis. As an example, even though some analysis of the crisis tends to indicate that lack of granularity was not associated with

[6] 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.

[7] Asset backed commercial paper conduits also embed maturity transformations but the risks of these are usually taken out by bank liquidity lines. We will deal in greater detail with ABCP conduits in our response to the ABCP question in the Consultation.

widespread failures, PCS believes that it would be unwise to abandon granularity requirements. At the risk of pushing a metaphor beyond its breaking point, generals may find themselves fighting the last war not just because they anticipate the same enemies but also because they ignore future potential enemies based on the fact that these were friends in the previous conflict. To pick on the granularity example once more, just because highly granular transactions failed – for reasons outlined above – does not mean that securitisations totally lacking in granularity are safe.

These considerations regarding the two stage approach to credit analysis, the notion of predictability and consistency as the essence of structural integrity and the lessons learned from the crisis are the conceptual framework PCS has brought to its response to the Consultation.

RESPONSE

We will now seek to deal with the questions set out in the Paper.

Question 1

We understand the aim of defining STC securitisation is to identify the type of securitisations for which risk assessment is not mired in complexity and uncertainty. This could lead to a return of a strong securitisation market without any concomitant return of the systemic risk that some types of securitisations and some behaviours around securitisation had allowed to build up prior to the crisis.

As we outlined in our general considerations above, PCS is supportive of this aim and also supportive of the approach outlined in the Consultation. This approach uses what we would define as structural integrity criteria to define a type of securitisation endowed with credit characteristics that are, all other things being equal, predictable and consistent. We believe, subject to some detailed comments on the individual criteria, that the type of criteria selected are indeed the type of criteria that are appropriate for this purpose.

We see three ways in which the approach of the BCBS and IOSCO will help in developing a sustainable securitisation market.

(1) Stigma

The crisis of 2007/2008, although it had many causes, is seen by many as a crisis rooted in securitisation. Had securitisations failed only in one dimension – such as US sub-prime RMBS – it may have been possible for commentators to write about it as a crisis of an asset class. However, as we outline above in our section on the four elements of the crisis in securitisation, different things went catastrophically wrong with different parts of that market. US sub-prime RMBS, CDOs of ABS and CDO squareds, SIVs, European CMBS all ran into difficulties to a varying degree. In addition, the generalised panic surrounding the technology, as well as the lack of transparency in some areas, led to mark-to-market losses and real “fire sale” losses across all asset classes.

With the benefit of seven years of development and much reflection, it is now possible for market participants, regulators and policy makers to understand better that it is not securitisation itself that is inherently flawed. The disasters connected to securitisation are connected to its uses and abuses. They are disasters of execution, not disasters of concept.

However, many investors continue to be understandably wary of the financing technique. Even if they accept the theoretical premise that the problems were in execution rather than design, they are not certain that they have the tools to distinguish *ex ante* structurally robust transactions from those that still contain some of the problems of the securitisations that failed in the crisis.

By setting out a simple and clear set of criteria and explaining their genesis in a deeper understanding of the crisis, the BCBS and IOSCO can assist investors to return with confidence to the markets. They also provide a conceptual toolkit for those investors who do understand the difference between structurally robust transactions and others to explain this difference to other less technically knowledgeable deciders in their own management or amongst end-investors.

(2) Differentiated and appropriate due diligence

Since the crisis, “securitisation” generally has been seen as an investment category fraught with extreme complexity and opacity. When one looks at some of the products such as triple layered CDOs of mezzanine tranches of residential sub-prime mortgage securitisations, this is understandable.

But the reaction of management and regulators has been to require analysts thinking of purchasing securitisations of any type, however simple, to perform heroic levels of due diligence. In addition to such pre-purchase work, these investors are also required to acquire and process, on an ongoing basis, large amounts of data.

Clearly, no-one wishes to suggest that investors should not perform all the necessary due diligence before purchasing an investment. However, the approach of treating all securitisations as similarly problematic, similarly opaque and similarly complex has resulted in investors being required to perform due diligence that is disproportionate to any conceivable risk in a simple and transparent securitisation and, secondly, far in excess of the due diligence that is deemed by general consensus as necessary for other equally simple and transparent types of investment.

This belief that all securitisations, whatever their structural characteristics, must be analysed as if they were CDO cubes has real world consequences for the chances of creating a sustainable securitisation market. An investor seeking to purchase even the most banal and robust senior RMBS will be informed that he or she will need to run models and simulations before and for so long as it holds the bonds. This means that data and modeling skills will need to be purchased. Often new analysts will also need to be hired as the number of transactions any analyst can review and monitor will be smaller than for any other types of capital market asset. One of the major impediments to new investors coming into the securitisation market is the upfront and ongoing costs of managing an asset-backed department. A European bank informed PCS recently that it had calculated the additional cost of buying a single asset backed security was €300,000 in data and modeling fees and additional staff. In simple terms, this means that if the spread between a securitisation and a corporate bond is 20 bps in favour of the former, the investor would need to purchase at least €150m in ABS before gaining a single euro from investing once more in this asset class. This is a major disincentive for any smaller player and, with European securitisation issuance as low as it is today, even larger players can struggle.

By defining STC securitisation as simple and transparent, the BCBS and IOSCO will allow the due diligence on these transactions to be reasonable and proportionate to the risk as well as in line with other simple and transparent products. This will be achieved without in any way undermining the higher level of work that is indeed required by those securitisations that do not meet the STC criteria.

(3) Differentiated and appropriate regulations

It is the essence of any prudential regulation that it must be benchmarked to the worst performer in the class being regulated. Since the riskiest products are usually the most profitable (at least until they fail) any other approach would set up dangerous regulatory incentives towards the creation of systemic risks. It is therefore key that regulations are able to divide up and categorise the universe of regulated objects or behaviours with sufficient discrimination to avoid closing down legitimate and safe avenues of financing yet doing so without allowing the build up of systemic risk[8].

In view of the catastrophic attributes of some types of securitisation, it was clear that following the crisis, strong regulatory rules would need to be introduced to prevent a repetition of the developments pre-2007. This has led to a substantial number of new rules being introduced around the world dealing with securitised products. However, in the absence of criteria differentiating the STC securitisations that had performed very well during the crisis from others, regulators and policy makers had, and still have, little option but to benchmark the regulatory rules to the worst performers. In other words, all securitisation would have to be treated as US sub-prime RMBS.

As the Consultation makes clear, this is unfair to those securitisations that are simple, transparent and comparable and did not suffer the type of catastrophic losses sustained by those transactions that contained one or more of the four elements that lead to a lack of structural integrity. This unfairness is not merely a matter of natural justice. By treating all securitisations in a punitive manner, the regulatory schemes will become one of the greatest roadblocks to the revival of a sustainable and resilient securitisation market. This will have substantial effects, especially in Europe, on the capacity of capital markets to fund the real economy.[9]

By creating a set of criteria to define the STC securitisations that are not prone to unexpected behaviour and a source of systemic risk, the BCBS and IOSCO are laying the ground for a bifurcated regulatory treatment of securitisation that will balance appropriately the needs of the real economy and the requirements of systemic stability.

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[8] An additional consideration in such parceling out is, of course, the issue of complexity and its impact of the capacity of both the regulators and the regulated to operationalise the regulatory rules.

[9] Although now a little dated, this argument was articulated by PCS in its 2013 White Paper (http://pcsmarket.org/wp-content/uploads/2013/03/Europe-in-Transition-Bridging-the-Funding-Gap1.pdf)

The criteria

We note that the proposed criteria seek to address only three of the four elements that are crucial for PCS in analysing structural integrity. The issue of iterative credit tranching (re-securitisations) is not. We believe this is a serious lacuna.[10]

Otherwise, subject to the detailed comments made in our response to Question 2, we note the proposed criteria contain additional positive elements similar in many cases to the PCS' own criteria. In this respect we believe that these criteria should indeed assist investors in identifying STC securitisations.

Question 2

As a general matter, the criteria set out in the Consultation derive from a conceptual analysis of what elements are relevant to the structural integrity of securitisations. Proceeding, as it does, from this type of analysis rather than a mechanical approach to failed transactions (i.e US sub-prime RMBS collapsed therefore lets ban sub-prime securitisation or US securitisation or RMBS) this approach strikes us as neither too complex nor inappropriate for a global context. The conceptual narrative that underpins these criteria is one of general application and is not rooted in the conditions of any particular jurisdiction or legal system.

Of course, as recognised by the Consultation, local investors and regulators may wish in a modular way to add specific provisions reflecting the local financial or legal circumstances. PCS has always been supportive of this "modular approach".

We will now seek to deal with each criteria.

Criterion 1 – Nature of the assets

We note a desire to limit the assets to those with a principal, interest or rental cash flow.

PCS agrees that STC criteria should contain some asset limitation since one cannot know *ex ante* whether some types of assets, as of yet unknown, contain elements that render them unsuitable for STC status.

However, a limitation as set out in the criteria appears to us to be both too limiting and too latitudinous. It may be too limiting as it is conceivable that an asset that presents neither principal or interest or rental payments could be entirely appropriate for a STC securitisation. It may be too latitudinous since it is equally conceivable that an asset with a principal component could be so structured as to be uniquely dangerous.

[10] It can be argued that the prohibition in Criterion 5 against initial asset selection could, indirectly, prevent resecuritisations from coming within the STC securitisation category. However, considering how important a "no-resecuritisation" criterion is to our analysis, we would very strongly recommend a direct and explicit reference.

PCS is also concerned that the criteria is based on what are fundamentally legal distinctions and could lead to "legalistic" arguments as to what really constitutes principal, interest or rental and to divergent outcomes for the same asset depending on local legal interpretations. We note that this has been somewhat anticipated by the Consultation's own footnote on page 12.

Our own suggestion would be to have a list of the types of assets that are by common agreement acceptable on their face. The PCS' own list, for example, contains residential mortgages, consumer loans including credit cards and auto loans, SME loans and various leases and auto-dealer loans.[11] We would then recommend that an agreed procedure be put in place to add, from time to time, any additional categories deemed to meet the requirements of STC securitisations.

We note that such a list also has the additional advantage of resolving the thorny issue of homogeneity: how similar must assets be to be deemed to be homogenous for the purposes of STC securitisation criteria? The answer can be that they must belong to a single listed category.

We agree with the criteria regarding the absence of complex derivatives and formulae. But, in common with the BCBS and IOSCO we do anticipate some difficulties in definition.

We also agree with the single jurisdiction rule but are less convinced about the single currency. (In practice, this may be of little relevance as the single jurisdiction rule is likely to reduce dramatically the number of potential multi-currency transactions.)

Criterion 2 – Asset performance history

We agree with the suggested approach and would encourage the BCBS and IOSCO explicitly to set out a time period. The EBA has suggested five years and this seems reasonable to us.

We would, however, suggest that it should be clarified that the performance data needs to be publicly available in respect of the relevant asset but not in respect of any given originator. Otherwise one would impose an unnecessary barrier to entry to new financial institutions seeking to fund themselves through securitisation.

With regard to the definition of "substantially similar credit or receivable" we believe that this is a very difficult and dangerous area. In essence, much of the US sub-prime debacle can be traced to the use by rating agencies and investors of performance data for a product called "sub-prime mortgage" which bore no relation to the product that was being securitised under that name following the transformation of the mortgage market in the years preceding the crisis. We believe that broadly similar products with very

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[11] Please note that the considerations that led to this being the PCS list of "labelable" assets are rooted in a complex history and that the list remains open to amendments. We are not suggesting that this is a definitive list of all the assets PCS considers acceptable for STC status.

different underwriting criteria are likely to have extremely different credit outcomes. We are therefore concerned that this criterion could lead investors to be unduly reliant on past data.

On the other hand, any attempt tightly to circumscribe the underwriting criteria in the definition of “substantially similar credit or receivable” will quickly lead into levels of complexity that will render this criterion unworkable.

Our suggestion is to keep the criterion but be explicit that it is to be used very broadly indeed. This should make clear to investors that they must not become reliant on this criterion when looking at past data. In other words, the criterion should not be seen as seeking to provide data sets for exactly the type of asset that is being securitised. It should be seen as a very high level criteria only, designed solely to eliminate entirely new classes of assets with no track record of any kind rather than to police credit analysis.

Criterion 3 – Payment status

We agree that securitisations with non-performing loans (NPL) pools or pools with a substantial portion of NPLs should not form part of the STC securitisation designation.

However, we also draw attention to the fact that some assets, such as credit cards receivables, emanate from business models where a certain percentage of defaults and certain rates of delinquencies are expected and catered for. In the cases of such assets, and in line with the criteria against “cherry picking” which appears in the Consultation’s Criteria 5, it is not just common but arguably desirable that some delinquent assets be securitised. It is desirable since, as defaults (and their recoveries) are part of the business model, investors will be able to get a better sense of the likely pool behaviour based on performance data that also includes these “business as usual” delinquencies.

In PCS’ own criteria, we have allowed certain specified levels of delinquencies for assets such as credit cards. We would therefore recommend a similar approach in the definition of STC securitisations.

On a point of technical detail, we would also wish to point out that in the case of master trust transactions (where securitisation transactions are issued over time and backed by the same master pool of assets to which new assets are added as and when), on issuance of any new securitisation it is entirely possible – and in fact likely – that some of the assets in the master trust will have become delinquent or defaulted since they were originally placed into the pool. In the PCS label criterion on defaulted assets, we deal with this technical issue by requiring that the assets not be delinquent or defaulted *at the time they are placed in the master trust*.

We agree that definitions of “default”, “delinquency” or “material increase” will be required. We think though that “defaults” and “delinquency” definitions are strongly linked to the asset class and, in some cases, the jurisdiction. A

missed payment on a mortgage may be a serious issue but, in some countries, a missed payment on a credit card is not. As a result, we do not believe that it is appropriate to come up with a single global definition of either of these terms.

Criterion 4 – Consistency of underwriting

This criterion gives PCS great concern. We understand that the issues of collapsing underwriting in the US sub-prime area are seen as one of the main triggers of the crisis. Accordingly, we can see the superficial appeal of a criterion that requires no decrease in underwriting standards.

However, we believe that such a criterion misunderstands the causes of the sub-prime catastrophe, is impossible to administer in practice, leads to illogical conclusions and will result in all originators eschewing STC securitisations. Thankfully, the problem can also be resolved in other, more effective, ways.

As we have set out above[12], the sub-prime problems did not the result from a collapse in underwriting standards but from the fact that this collapse (or, at least, its depth) was not understood by rating agencies and investors. Had it been correctly assessed, increases in credit enhancement would have been able to compensate for the likely increases in losses flowing from this collapse. It was the existence of pure originate-to-distribute models that encouraged originators not just to cause such a collapse but also to minimize its impact when speaking to rating agencies, investors and regulators.

The reason this criterion is impossible to administer in practice is that banks change their underwriting criteria constantly and in ways that make it difficult to determine whether there was a deterioration. For example, banks may lower their criteria as a result of having more data and therefore feeling more confident in their capacity to measure risk. Sometimes some underwriting criteria are lowered because others are heightened. A bank may increase the loan-to-value it is prepared to accept on a mortgage but only for customers that have banked with it for more than a certain period. Finally, when some criteria are changed, it becomes a matter of debate as to whether or not a deterioration has occurred. A bank may lower the age of the borrowers it is prepared to advance car loans to by asserting that there is no good reason to believe losses are more highly correlated with youth. Whether this is a deterioration of underwriting depends on your views on the accuracy of this statement. In each case, knowing whether the underwriting criteria have "deteriorated" is fraught with highly subjective judgments and controversy. It is unlikely that any consensus could ever be achieved regarding the "correct" answer or even if there is a "correct" answer.

For all these reasons, PCS believes this criterion cannot be sensibly administered.

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[12] In "four elements" on page 6.

In addition, as mentioned above, an announced and transparent lowering of underwriting criteria matched by a concomitant increase in credit enhancement for the securitisations is unobjectionable. It certainly would not remove a securitisation from the STC category. This is self-evident if one takes the example of two banks securitising loans. Bank A applies underwriting criteria X and Bank B applies underwriting criteria Y. Criteria Y happen to be looser than criteria X. Both issue STC securitisations. However, Bank A decides to migrate to underwriting criteria Y (and accepts, for its new securitisations, a higher level of credit enhancement). Now both banks are issuing securitisations identical in all respects – both as to underwriting criteria and credit enhancement. However, under the proposed criterion, Bank B's securitisation is still an STC securitisation but Bank A's, although identical, is not since it proceeds from "deteriorating underwriting criteria".

Finally, a requirement that banks never lower their underwriting criteria if they wish to maintain access to the securitisation market will prove, we fear, an unacceptable shackle on the necessary freedom of a bank to adjust its lending strategy and risk/reward appetite in the face of changing economic and market conditions. We struggle to see how a bank could seek to rely on securitisation as a key funding source if this meant that it could never compete with other banks or change its lending strategy.

However, we feel that the objectives of this criterion can be met more readily by the retention of a material interest (Criterion 12) and the various transparency criteria which should, especially when combined with a criterion against "cherry picking" (Criterion 5), preclude the opaque deterioration of lending criteria that resulted in the US sub-prime crisis.

Criterion 5 – Asset selection and transfer

We strongly agree that securitisations with "managed pools" should not be eligible for STC status. In our opinion, such securitisations operate as funds rather than bonds. There is nothing intrinsically problematic with funds, a ubiquitous investment channel, but they should be governed by different regulatory and analytical rules.

We note that this criterion will also eliminate synthetic securitisations. This is a matter that PCS considered in depth in its response to the recent EBA consultation and we expressed our view in our response to that paper[13] which we would refer you to.

A summary of this view is that synthetic securitisations can be a safe investment and are potentially of great benefit for the financial system, particularly as a risk diversification tool. However, the rules regarding structural integrity of synthetic securitisation are different and more complex than for traditional "true sale" securitisation. We therefore accept that they are

[13] See http://pcsmarket.org/wp-content/uploads/publications/5eebc/FINAL_PCS_EBA_response_14-01-15.pdf on pages 12 et sub.

not good candidates for STC status but would encourage a work stream to begin crafting similar criteria for a STC synthetic securitisation category.

We strongly support the notion of random selection of assets as it is the only way in which the retention criterion for alignment of interest can be made effective.

We broadly agree with the definitions of what constitutes a "true sale" and agree with the no encumbrance rule.

As a technical matter, we are not clear what was the purpose of requiring claims to be enforceable against "any third party". We are not sure what third parties this criterion contemplates but would suggest that it is only necessary that the claim be enforceable against the obligor.

Also as a technical matter, in all the jurisdictions with which PCS is familiar, sold claims are only beyond the reach of the creditors of the seller in the seller's bankruptcy if certain fact patterns obtain (eg the claims were not sold at an undervalue). Therefore, no absolute comfort can ever be given on this point and the criterion can only work in practice if only the traditional strong but still relative comfort on "true sale" is required.

Criterion 6 – Initial and ongoing data

We agree that for micro-granular pools such as credit card receivables, stratification tables are appropriate. We also strongly agree with both quarterly investor reports and the existence of a third party "audit".

Criterion 7 – Redemption cash flows

This criterion seeks to remedy the problems of embedded maturity transformation, one of the four elements of the crisis. We are therefore strongly supportive.

We note, however, that the criterion does allow for embedded maturity transformation provided that there is sufficient granularity in the pools and the sales or refinancings are scheduled over a long enough period. PCS accepts that, in theory, a combination of granularity and scheduling could overcome the problems of embedded maturity transformation. However, we are concerned with the complexity of determining what levels of granularity and what length of the sale or refinancing period would be sufficient. We therefore wonder if this exception would not potentially undermine one of the key criteria of STC securitisations. Without wishing to close the door on such exception, we would only recommend that it be part of the criteria for STC securitisation with very clearly defined boundaries. Such boundaries would have to be set, though, asset class by asset class and country by country.

Criterion 8 – Currency and interest rate asset and liability mismatches

We agree with this criterion.

Criterion 9 – Payment priorities and observability

We agree with the various provisions of this criterion.

Criterion 10 – Voting and enforcement rights

We strongly agree that all voting rights regarding the securitised assets should vest in the investors upon insolvency of the originator or sponsor or its default on fundamental obligations.

With regards the allocation of voting rights as between senior noteholders and junior noteholders, we feel the vesting of key voting rights to the junior tranche investors is not an illogical approach. Although a cursory analysis would assume that the senior investors should, having regard to their seniority, have the voting rights, this is sometimes not sensible. The reason for this is that voting rights tend only to be relevant when things go wrong and the securitisation needs to be modified or the securitised assets needs to be dealt with. In this case, the view is usually expressed that the junior investors are at most risk. Therefore, they are expected to act rationally and seek to maximise the overall returns since any losses fall first on them. By seeking to avoid or minimise losses falling to them, the junior tranche investors automatically protect the senior note investors. On the other hand, senior tranche investors have no interest in minimising any losses that are less than the junior tranche credit enhancement. So, acting rationally, the senior note investors – in contradiction with junior note investors – have no incentive or motive to help the other noteholders. With no voting right, the investor in a junior note has little hope that, if a difficulty arises, it will obtain any relief.

Therefore, vesting all the voting rights in the senior note investors will, in our view, create potentially substantial disincentives for junior investors.

On the other hand, senior investors must have control of any voting on the core provisions of the transaction such as forsaking principal or interest, changes to the basic terms of the securitisation such as the maturity date or the coupon or transfers of the assets to a new special purpose vehicle.

An approach that seems to balance these two requirements would be for the STC securitisation criteria to specify a list of basic terms modifications that must remain within the control of the senior noteholders but allow the junior noteholders to retain control of the disposal or management of the securitised assets following an originator or sponsor default or insolvency. This is the traditional manner in which these issues are dealt with in most securitisations that come to market and PCS is supportive of this approach.

Criterion 11 – Documentation disclosure and legal review

The issue of the disclosure of documentation prior to the issuance was also raised by the EBA in their recent consultation. We will therefore restate our response to that document:

"PCS believes that, although superficially attractive, the disclosure of documentation prior to issuance poses not only serious practical but also profound conceptual issues.

Practically, the disclosure prior to issuance of documentation is very difficult since some of the data that is required to go into such documentation can only arise between pricing and close.

More serious though is the conceptual (and potentially legal) difficulties this would raise. It is a legal requirement of all capital market transactions that the prospectus contain all the information that an investor would deem relevant to making an investment decision. If the entire documentation is published, what is the relationship between this documentation and the prospectus?

It strikes us that a publication prior to issuance of the entire documentations raises some complex issues regarding the liability regime surrounding the placing of debt securities. It could, for example, lead to differences in the timing, quantum and nature of the liability falling on the issuer as between securitisations and other debt instruments. Such differences, in turn, could impede a return of securitisation.

PCS therefore believes such disclosure is impractical, unnecessary and likely to cause extremely substantial legal issues."

That said, we have no issues concerning the availability of transaction documentation soon after issuance and during the period in which the securitisation bonds are outstanding.

Criterion 12 – Alignment of interest

As PCS sees the problems of misaligned interest as one of the keys to the crisis, we believe this criterion to be one of the essential and necessary pillars of any STC securitisation definition.

One of the key benefits securitisation can bring to the financing of the economy is the possibility to generate additional bank lending without additional bank capital being raised. This can uncouple the issue of the availability and price of bank capital from the issue of the amount of credit that an economy may require to fund growth. Therefore, PCS is a strong supporter of what is known as "vertical slice" retention, where the originator retains an economic interest in the whole pool. This was the situation in Europe prior to the crisis and we believe is the key reason why European securitisations in the traditional asset classes performed so well.

We therefore not only support retention but would urge the retention definition not to be so crafted as to prevent "vertical slice" retention. We note that this is appropriately the case in the Consultation and would argue that it is important that it should remain so in the final proposals.

We have no strong views either way on the idea of a party with fiduciary responsibility to investors in reviewing and confirming the alignment of interest. We do believe that the originator should clearly set out the manner in which it has retained its interest – rather than merely making a declaration that it has.

Criterion 13 – Fiduciary and contractual responsibilities

We broadly agree with this criterion, but note that some aspects of it are quite vague and may be very difficult to monitor.

We would suggest that rather than stating that the servicer or parties with fiduciary responsibility should act in a particular manner at all time – a fact that can only be verified *ex post facto* rather than at issuance of the securitisation – the criterion should read that these parties are bound by contracts that require them to act in accordance with these requirements.

Another contractual requirement that might fit well within this criterion is a provision binding on originators that are also the servicer of the assets post securitisation that, in the management and enforcement of securitised claims, they must act in a non-discriminatory manner. In other words, they must apply the same rules and treatment *mutatis mutandis* to the assets they have securitised as they apply to those they have not.

Criterion 14 – Transparency to investors

We support this criterion

On the issue of whether additional criteria would be warranted, we re-iterate our view that re-securitisations should be explicitly excluded from the STC securitisation category. We believe this to be essential.

PCS also believes that granularity is an important element of structural integrity. Accordingly, we believe that some minimum granularity requirements should form part of the definition of STC securitisations.

Question 3

Our views on ABCP are very similar to those we expressed in our response to Question 2/Criterion 5 on synthetic securitisation . ABCP is a good product but with credit dynamics that are quite different to term securitisations and focusing on the nature and extent of the attendant liquidity facility.

As with synthetics, we believe that there is great potential benefit in crafting STC securitisation criteria for ABCP. However, seeking to conjoin these with the STC securitisation criteria for term securitisation is impractical and would result in unnecessary delays. We do, however, strongly urge that this important and valuable channel of finance be the subject of a working group as soon as possible.

PCS does not label ABCP issuance. As such, we do not possess a set of ABCP quality criteria, nor have we worked on developing a set. We are therefore not in a position to make concrete proposals at this stage but stand ready to assist in any way we can.

Question 4

PCS' view is that there is a fairly low level of standardisation within securitisation but that this level is rising. In this respect we note the positive work of the Dutch Securitisation Association on the standardisation of RMBS[14] and our own work with British RMBS issuers to standardise certain representations and warranties. Of course, through its extensive criteria that require to be met in order to obtain the label, PCS is itself an agency of standardisation.

Our thoughts on standardisation are as follows;

1. It is often said that differences in legal frameworks and financial practices render standardisation of securitisations impossible. Although this is, to some extent, true and absolute standardisation is not feasible, there remains a huge amount that can be standardised.

2. A greater level of standardisation would be very positive for the development of a sustainable securitisation market and should be encouraged as a key priority.

3. Standardisation is something that we can see as very beneficial within each asset class (mortgages, auto loans, SME loans, etc…). Standardisation across asset classes becomes rapidly quite difficult except for fairly trivial aspects. In addition, PCS is not convinced that cross-asset class standardisation brings substantial benefits.

4. Greater standardisation across jurisdictions is, in our view, entirely feasible and to be encouraged. However, as a process matter, we strongly encourage that standardisation efforts as a first stage should be done within each jurisdiction or region and, then, as a second stage, across jurisdictions. This will be more likely to yield results.

5. Although public sector involvement and encouragement will be important, we strongly urge that standardisation be done by and through industry bodies. We believe that "from the bottom up" standardisation led by an issuer/investor partnership is much more likely to produce positive results for the investor community than "from the top down" standardisation introduced by regulation. Once more, the work of the Dutch Securitisation Association and PCS in this field are good example of what can be achieved.

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[14] http://www.dutchsecuritisation.nl/terms-website-use-agree

6. Although standardisation is often seen as a simple process, PCS is aware that the standardisation of items such as definitions are not merely a matter of preference. Changes to definitions, for example, can (and often do) lead to a requirement for originators to change procedures and IT. These are changes that can result in substantial costs for issuers. Therefore, although we are strongly in favour of standardisation, we believe that it should take place with due awareness of and consideration for the costs/benefit realities.

7. The areas where we believe standardisation will be possible and beneficial are as follows:

   (a) Standardisation of the internal structure of prospectuses. This should ensure that investor can navigate with ease the prospectuses of different issuers, with each item in the same location and arranged in the same manner.

   (b) Standardisation of definitions used in prospectuses. For the reasons mentioned in point 6 above, PCS believes this should be done – at least for an initial period – on a "comply or explain" basis. If an originator choses to use a different definition, this should be clearly set out in a separate section of the prospectus with an explanation of the differences with the standard definition.

   (c) Standardisation of investor reports both as to their internal structure and the definitions of terms used in the reports. Again, for the latter and at least for an initial period, this may be done on a "comply or explain" basis.

   (d) Standardisation of loan level data or stratification tables. This standardisation should be both as to the type of data disclosed, the format of disclosure and the definitions of the terms used in the data disclosure.

   (e) Standardisation of originator representations and warranties regarding the assets and their transfer. As an example of this we draw your attention to the standard representations and warranties that appear in the PCS label criteria.[15] Again, and at least for an initial period, this should be done on a "comply or explain" basis.

   (f) Standardisation of the voting rights of investors and the duties of parties with fiduciary obligations so as to protect investors from the unpleasant surprises that many had during the crisis when transactions suffered difficulties and the investors discovered that their rights were not as they had anticipated.

[15] PCS Label Criteria (http://pcsmarket.org/wp-content/uploads/2014/11/V8-Eligibility-Criteria-draft-CLEAN-121114.pdf)

CONCLUSIONS

We believe the Consultation is a very positive step towards creating a sustainable and safe global securitisation market.

We strongly agree with the approach: conceptual, based on two stages and seeking to define structural integrity rather than credit quality.

We broadly agree with the proposed criteria, save for the absence of a criterion dealing with iterative credit tranching. We do believe though that a number of refinements should be made and a few criteria removed, as set out in our response to Question 2.

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