A response to the Bank of England and ECB discussion paper

4th July 2014

PCS

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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/EILIGIBILITY-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/EILIGIBILITY-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.

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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

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[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.