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T: +44 (0)20 3440 3720
E: info@pcsmarket.org

Prime Collateralised Securities
(PCS) UK Limited
40 Gracechurch Street
London EC3V 0BT

www.pcsmarket.org

European Banking Authority
One Canary Wharf Square
Canary Wharf
London
United Kingdom

Dear Sir or Madam

Consultation paper on the draft RTS on the homogeneity of the underlying exposures in securitisation

Prime Collateralised Securities ("PCS") would like to thank the EBA for this opportunity to comment on the potential draft RTS concerning the homogeneity criterion under the STS Regulation. We would also like to commend the EBA on the work they have done and the rigorous approach they have displayed in dealing with this difficult article of the STS Regulation.

PCS has openly and repeatedly commented that the entire STS enterprise and, with it, the hope of a strong recovery of the European securitisation market to fund European growth will turn on a series of rules to define the new "simple, transparent and standardised" standard that are clear, capable of being practically put into effect and commercially feasible. Whilst quite properly, staying within the ambit of the legislative text and intent, the EBA's approach, as set out in this consultation paper, seeks to achieve these aims.

Overarching principles

Before responding to the individual questions set out in the consultation, PCS would like to set out two fundamental overarching principles which we think should guide the approach to any interpretation of the homogeneity criterion of the STS Regulation. This will throw light on our responses to many of the questions in the consultation. We also hope that the EBA can accept these two principles as framing their own approach.

The purpose of the homogeneity criterion in STS

By common understanding, the "simple, transparent and standardised" category was designed by the Commission and Co-legislators to draw a line between, on the one hand, the high-performing, plain vanilla, standard European securitisations that formed the bulk of pre-crisis securitisations and,

on the other hand, the small group of opaque and over-engineered and often over-leveraged products (often from without the European Union) that caused so much destruction during the crisis. The exceptionally good credit performance of the vast majority of standard European securitisations since the onset of the crisis was cited repeatedly by the European Commission, the European Council and the European Parliament as one of the reasons for the creation of a new regulatory category that could encompass such standard products.

Turning specifically to the issue of homogeneity, having participated in dozens of discussions with regulatory authorities, the Commission and the Co-legislators, we have absolutely no doubt that there has never been, nor is there today, a perception that there is a lack of homogeneity in any of the plain vanilla securitisations that constitute the bulk of European issuance. Put in other words, the homogeneity criterion of the STS Regulation was not introduced to deal with a real and endemic issue with current and past market practice but to ensure that rare exotic securitisations that may contain heterogeneous pools cannot benefit from the STS designation and do not become a meaningful component of the European securitisation landscape.

This view is also entirely consistent with the approach of all investors that PCS has approached: none have expressed the view that the plain vanilla transactions they purchase are not homogenous.

Taking these two facts into account, it therefore appears to PCS that no interpretation of the homogeneity criterion that wishes to respect the legislative intent can result in the exclusion from the STS category of any of the types of securitisations routinely issued in Europe in any meaningful volume and considered by universal consensus to be plain vanilla, simple and standard products.

The need for a workable and therefore clear STS standard

The sanctions provided for mis-certification of an STS securitisation are extremely severe. As a universal legal principle, the more severe the sanctions the more clarity and certainty is required in the definition of the offence. Very severe sanctions coupled with a loose and hard to interpret offence will simply lead those who may be subject to the sanctions to withdraw altogether from activities that could lead to their imposition.

In the STS regime, this means that loose and difficult to interpret criteria run a real risk that originators will simply not make use of the STS designation. This would lead to an unfortunate collapse of the STS project and the hopes it carries for a regeneration of a safe European securitisation market.

In addition, PCS believes, as did the Co-legislators, that an important role will be played in the STS regime by regulated third party certification agents. This, however, creates a heightened need for clear and determinable standards. It is possible that an originator may be prepared to certify a transaction despite uncertainty in the interpretation of a given criterion because of a rational

analysis of the balance of risk and benefit it derives from such certification. A third party certification agent cannot. The third party certification agent's role is not to balance the commercial risks and benefits of certification but to make an independent assessment of the justification for seeking STS status for a given transaction. For it to be able to perform such a role, it must have a clear set of objective rules it can apply.

The need for clear standards allowing a reasonable actor to make a reasonable determination as to whether the homogeneity criterion is met for any given transaction is made difficult however, and especially in the case of the assessment of paragraph (d) of the proposed four part test, by the infinite possible permutations of putative securitisation structures.

Nevertheless, such clarity is essential.

As this issue is most troublesome with part (d) of the proposed test, we shall deal with it more fully in the relevant part of our response to Question 8.

Q1: Do you agree with the focus of the RTS, general approach and underlying assumptions on which the RTS are based? Does the proposed approach provide sufficient clarity and certainty on the interpretation and application of the criterion of homogeneity?

PCS continues to believe that the best reading of the words "taking into account the specific characteristics relating to the cash flows of the asset type including their contractual, credit-risk and prepayment characteristics" is that this represents simply a general description of what makes an asset class such as "residential mortgages". As a matter of legal interpretation, PCS does not believe that it is correct to ascribe to those words additional effect above and beyond limiting homogeneity to an asset class. We base our interpretation on the clear words of Recital 27, where the text unambiguously describes a homogeneous pool as defined by the belonging of each asset to a single asset class without any reference to additional requirements.

However, we understand that a different view may have prevailed. Although we cannot agree, we accept that if the additional words are to be treated as normative rather than descriptive, the general approach of the EBA in the consultation document is sound and consistent.

In particular, we believe that an approach focusing on the investor's capacity to assess a pool of assets "on the basis of common methodologies and parameters" is correct and consistent with the underlying principles behind this STS criterion.

PCS also believes however that additional clarity needs to be provided in a number of places.

In (a), the expression "similar underwriting standards, methods and criteria" does not assist in determining the level of "coarse graining" that it is necessary to apply in defining "similarity". The words could give the

impression that all the assets need to be underwritten on the same basis according to the exact same thresholds. This, of course, is neither practical nor sensible nor what we believe the EBA was trying to capture.

To illustrate, a pool of residential mortgages in a securitisation may have been originated during a period of four or five years. These mortgages will have been originated in the same bank, by the same underwriting team using the same software and the same data sheet. But at some point, the bank may have decided to raise its LTV requirements from 75% to 85% and compensated by lowering its income cover. No investor we have ever encountered would consider these two types of mortgage heterogeneous.

Similar issues may arise when a bank has originated similar assets in different subsidiaries using, possibly for legacy reasons following a merger or acquisition, different IT systems and software but where the bank's centralised underwriting guidelines are expressly designed to achieve the same basic underwriting outcome based on the same fundamental approach to credit risk.

The essence for PCS of underwriting consistency is whether the underwriting has been done by capturing the same types of parameters and using them to measure the same types of risk to generate assets that occupy broadly the same risk category.

We therefore suggest replacing "similar underwriting standard, methods and criteria" with an expression such as "according to broadly similar underwriting approaches focusing on generally similar inputs designed to measure generally similar credit risks".

We think this captures the notion of avoiding pools underwritten on a fundamentally different basis (eg focusing solely on collateral recovery value vs focusing only on credit history) without requiring an absolute but counterproductive uniformity.

In (b), the expression "serviced according to uniform servicing procedures…" could, at its most conservative, be seen to limit the servicers' rights to apply discretionary exceptions to the servicing. This, especially in consumer lending, is not in the interests of customers who may have legitimate and special circumstances justifying a more lenient treatment than prescribed by the "uniform servicing procedures". It is also not consistent with best practice in maximizing returns from debt.

We suggest adding the words "and without prejudice to the proper exercise of servicer discretion" before the words "uniform servicing procedures".

For the same reasons as set out for (a), we would also suggest replacing "uniform" with "broadly similar" before "servicing procedures".

PCS is also puzzled by the addition of the words “administration and allocation”. These issues are not related to the homogeneity of the assets or, for that matter, to the assets in any way. The administration of the cash once received is a matter of the servicing and the account bank arrangements. These are issues connected to the securitisation structure. Similarly, the allocation of cash is a matter for the securitisation “waterfall”. There are a number of other STS criteria that explicitly deal with those structural elements. The homogeneity criterion is solely an “asset type” criterion and should not be extended to cover structural elements.

We suggest that the words “administration and allocation” be removed.

For concerns regarding (d) we refer you back to our response to Question 8.

Q2: Do you agree with the assessment of the homogeneity of underlying exposures based on criteria specified under (a) to (d)? Should other criteria be added or should any of the criteria be disregarded?

For the reasons set out in our response to Question 1, we do not agree with the approach breaking down homogeneity into four elements.

However, if the alternative legal analysis of the text does prevail, then we agree that the current approach is sound. On that basis, PCS does not believe any additional criteria are required or that any of the suggested criteria should be disregarded.

Q3: Are there any impediments or practical implications of the criteria as defined? Are there any important and severe unintended consequences of the application of the criteria?

We refer back to our answer to Question 1.

Q4: Do you agree that when considering the relevance of the risk factors, the asset category, type of securitisation (non-ABPC or ABCP), and specific characteristics of the pool of exposures, should be taken into account? Should other elements be considered as important determinants of the relevance of the individual risk factors?

PCS believes these should be taken into account. We cannot think of any other elements that should be taken into account.

Q5: Do you agree that the same set of criteria should be applied to non-ABCP and ABCP securitisation? Or do you instead consider that additional differentiation should be made between criteria applicable to non-ABCP and ABCP securitisation, and if so, which criteria?

Homogeneity is a criterion that goes toward the simplicity of investor analysis. As such, it has always been an odd fit for ABCP.

First, as is clearly recognised in other parts of the STS Regulation regarding disclosure and investor due diligence, the Co-legislators correctly accepted that the appropriate credit risk for investors to focus on in asset-backed commercial paper was the credit risk associated with the fully-supporting liquidity line and therefore the conduit sponsor. Since the complexity of the investor due diligence resides in his or her assessment of the sponsor, the heterogeneity of the underlying asset pools contained in the conduit is an irrelevance.

Secondly, since there are invariably multiple transactions funded by any ABCP conduit and the homogeneity requirement only applies to individual transactions and not the program as a whole, the investor in ABCP always has to deal with a heterogeneous asset base.

Where the homogeneity requirement may therefore make sense as a simplicity criterion is not for the commercial paper investors but for the sponsor. However, the sponsor is in a completely different position from that of an investor in a stand-alone STS securitisation. The latter will be purchasing a transaction arranged by a third party backed by assets underwritten and originated by the same or another third party. In the case of an ABCP sponsor, the sponsor is the credit underwriter, the originator and the arranger. To add to this picture, by law, the sponsor must be a regulated EU bank.

It follows that the entity "benefiting" from the homogeneity criterion in an ABCP conduit is, by law, a sophisticated institution with the greatest possible amount of information and control over the assets that compose the asset pools in the securitisation. Therefore, it seems that a lower level of "protection" is called for in ABCP conduit when it comes to restricting the assets that can make up a transaction.

PCS would suggest that only (a), (b) and (c) should apply to ABCP conduits.

Q6: Do you agree with providing a list of asset categories in the RTS? Do you agree with the asset categories listed? Should other asset categories be included or some categories be merged? For example, should separate asset categories of project finance, object finance, commodities finance, leasing receivables, dealer floor plan finance, corporate trade receivables, retail trade receivables, credit facilities to SMEs and credit facilities to corporates, be included? Please substantiate your reasoning.

For the sake of clarity, PCS believes that it is very beneficial to list the key asset categories. This should help lift uncertainty with respect of this element of the homogeneity criterion for the greatest part of the likely market. PCS also agrees that this list should be non-exhaustive and this be set out clearly in the recitals.

PCS hopes that, under the provisions of the STS Regulation empowering the EBA to issue guideline and recommendations concerning the STS criteria, the EBA will feel able, as the market develops, to suggest additional asset classes. (We accept that those possible additional classes will not have the same legal status as those set out in a Regulatory Technical Standard).

PCS would agree that dealer floor plans should be a listed asset category.

Although PCS believes that an argument could be made to separate SME loans into a separate asset category from large corporate loans, we would caution that this should only be attempted if the definition of "SME" remains very flexible and explicitly encompasses mid-caps. This is certainly how investors and issuers understand homogeneity in this area. **Under no circumstances should there be an attempt to circumscribe SME loans as an asset category that only covered micro-enterprises or that used the definition used by the European Commission. That definition was crafted for totally different policy purposes than debt risk analysis. To carry it over to the STS rules is illogical.**

On balance, PCS thinks the current article 2(d) is appropriate, bearing in mind that the risk factors and the broadly similar underwriting requirements should be sufficient to eliminate pools mixing micro-enterprises and large multi-nationals.

Another consideration is that an asset may belong to two or more asset categories. For example, an SME loan (category d) may be secured on commercial property (category b) or, in the case of sole traders, could be considered a loan provided to a natural person (category c). The proposed article 2 only requires that all the assets belong to one category and does not require, should an asset fall into two categories, all the other assets in the pool should also fall into that second category. ***PCS does not believe that the text needs amending but, for the sake of clarity, it would be useful to set this out in a recital.***

Q7: Do you agree with the definitions of the asset categories provided? For example, do you consider that the asset category of credit facilities to SMEs and corporates should be further specified and for the SMEs should refer to the definition provided in the Commission Recommendation 2003/361/EC, or should other reference be used (for example to Art. 501 of the CRR)? Please substantiate your reasoning.

Generally yes, subject to the points made in our response to Question 6.

Q8: Do you agree with the approach to determination of the homogeneity based on the risk factors, and the distinction between the concept of risk factors to be considered for each asset category, and relevant risk factors to be applied for a particular pool of underlying exposures, as proposed? Are there any impediments or practical

implications of the risk factors as defined? Are there any important and severe unintended consequences of the application of the risk factors?

Subject to our overall views as set out in our response to Question 1, we accept that this approach makes sense.

In our introduction dealing with principles, we indicated the absolute need for clarity such that an issuer and a third party certification agent are able to determine, in the vast majority of cases, whether a transaction meets the STS requirements. We also wrote that this issue is particularly acute for the risk factor portion of the proposed EBA text.

In order to achieve this clarity, PCS believes the EBA may have but two options.

First, it may produce an "algorithm" that will allow an originator and a third party certification agent to assess, in each possible case, whether the homogeneity criteria is met. This is fraught with difficulties: it is exceedingly challenging to do so in a way that, on the one hand avoids a reductionist approach that artificially constrains otherwise perfectly homogeneous transactions but, on the other hand, is not so loose as to allow "gaming" by market participants.

There is a second option, which PCS finds more balanced and workable, especially when one bears in mind our comment earlier in our response that lack of homogeneity has never been perceived by anyone as a widespread issue in European securitisations.

This is for the RTS to state clearly that, although the final decision as to what is homogeneous remains, of course, with the national competent authorities, absent any clear evidence of abuse or bad faith, the national competent authorities should pay due deference to the judgment of an originator as to what factors are relevant in determining homogeneity in any given pool. The RTS may also add that, in cases where the originator's judgment is backed by the judgment of an independent regulated third party certification agent, only evidence of bad faith, misleading statements to the third party certification agent or dishonest collusion between the originator and the third party or clear contravention of a published regulatory interpretation should lead a national competent authority to overturn the originator's judgment.

PCS suggests the following amendment as an additional final paragraph to the proposed article 1:

"The determination by the originator of the relevance of any risk factor shall, when certified by a third party certification agent as provided for in Article 27.2 of the [STS Regulation], be determinative unless it can be shown that:

- ***the originator knowingly acted in bad faith;***

- ***the originator and the third party certification agent colluded to act in bad faith;***

- ***the originator knowingly misinformed the third party certification agent to induce it to agree to a determination of relevancy;***

- ***the determination of relevancy is in contravention of a published regulatory interpretation;***

- ***it is determined by a relevant national competent authority that no reasonable originator or third party could have reached the relevant determination of relevancy."***

Q9: Do you agree with the distribution of the risk factors that need to be considered for each asset category, as proposed? What other risk factors should be included for consideration for which asset category?

The table setting out the distribution of risk factors appears sensible.

Q10: Do you agree with the definition of the risk factor related to the governing law, which refers to the governing law for the contractual arrangements with respect to the origination and transfer to SSPE of the underlying exposures, and with respect to the realisation and enforcement of the credit claims? Do you consider the risk factor of the governing law should be further specified, or further limited (e.g. to the realisation and enforcement of the financial collateral arrangements securing the repayment of the credit claims)?

PCS notes that the issue of the adequacy of the transfer of the assets to the SSPE is already covered by another STS criterion (in Article 20.1 of the STS Regulation).

As for origination, the governing law, is in many cases, irrelevant since consumer protection rules impose the local law. As a result, the location of the borrower is more relevant than the purported law of the contract. We note that this is risk factor (i).

As for realisation and enforcement of legal claims, this is a complex issue of which the law of the contract can be but a small component. For consumer loans, the location of the consumer, and for immovable property that of the property, are more relevant than the choice of law clause in the contract.

For larger corporates, setting aside the vexed question of the "center of main interest" (COMI), so many other factors enter into the analysis of likely recoveries that the relevance of the law of the contract as a sole data point is highly questionable when looking at a pool of loans.

The location of the borrowers, however, is often a very meaningful element in determining homogeneity.

Therefore, it seems to us that category (j) does not add to category (i) and should be eliminated.

In respect of category (i), we think the use of the term "jurisdiction" is unhelpful. "Jurisdiction" is a legal concept that does not capture the very real importance of location. For example, Scotland and England and Wales are two separate jurisdictions but are considered, to use a colloquial expression, "the same place" when determining homogeneity for almost all asset types. This is not just because of the similarities of the laws of the two jurisdictions but also because of the cultural similarities, the identity of the main actors (British banks), the single central government and central bank and the close economic ties driving similar economic cycles. Similarly, many investors consider the Nordics or the central European grouping of Hungary, Slovakia, the Czech Republic and, in some cases, Poland to be a single area when analyzing certain (but not all) types of risk. Therefore, it seems to us that a better way of capturing the genuinely important concept of location (a pool of residential mortgages made up of German and Cypriot mortgages is unlikely to be homogeneous) is "jurisdiction or set of jurisdictions". This would allow a definition of homogeneity that captured the genuine importance of geography without falling prey to artificial divisions amongst legal systems.

PCS therefore suggests adding the words "or set of jurisdictions" after both words "jurisdiction" in category (i), together with a brief recital explaining the general approach.

Q11: Do you consider prepayment characteristics as a relevant risk factor for determining the homogeneity? If yes, based on which concrete aspect of the prepayment characteristics of the underlying exposures should the distinction be made, and for which asset categories this risk factor should be considered and should be most relevant?

This is a difficult, albeit not a very crucial, issue. On the one hand, the list of items that can be part of a proper investor due diligence and, therefore, incorporated in that investor's methodological approach is potentially extremely long. In can certainly be argued that, for certain asset classes, prepayment characteristics are something that an investor might take into account. Is it a sufficiently important one to be included in the list of homogeneity risk factors? On balance, PCS' view is that it probably does not warrant inclusion but that it is not fundamentally wrong to have it in the list either.

Q12: Do you consider seniority on the liquidation of the property or collateral a relevant risk factor for determining the homogeneity? If yes, do you consider the distinction between the credit claims with higher ranking liens on the property or collateral, and credit claims with no

higher ranking liens on a different property or different collateral, as appropriate for the purpose of determination of homogeneity?

PCS does consider the seniority on the liquidity of property or collateral a relevant risk factor to be considered.

PCS also considers that whether security is first ranking or second ranking is usually a risk factor and, in most cases, should have a strong bearing on the conclusion as to homogeneity.

Please note though that a transaction where second ranking collateral can only be in the securitised pool if it is second ranking to another loan with first ranking security in the same securitised pool, is not heterogeneous. In effect, from a risk analysis perspective, the technically separate assets (the loans with respectively first and second ranking charges to the same borrower) are treated as a single economic asset, even if they are legally separate. And economically, these single assets have functionally first ranking security.

We suggest that a recital to that effect would be very helpful.

Q13: Do you agree with the approach to determining the homogeneity for the underlying exposures that all do not fall under any of the asset categories specified in the Article 3?

As one cannot determine *ex ante* what the characteristics of assets other than assets belonging to the listed classes will be, it seems very reasonable that each risk factor should be considered.

Q14: Do you believe that materiality thresholds should be introduced with respect to the risk factors i.e. that it should be possible to consider as homogeneous also those pools which, while fully compliant with requirements under Article 1 (a), (b) and (c), are composed to a significant percentage (e.g. min 95% of the nominal value of the underlying exposures at origination), by underlying exposures which share the relevant risk factors (e.g. by 95% of general residential mortgages with properties located in one jurisdiction and 5% of income producing residential mortgages located in that and other jurisdictions)? Please provide the reasoning for possible introduction of such materiality thresholds.

The potential sanctions on issuers who are found to have mis-certified a transaction STS are extremely severe. Additionally, the mark-to-market cost to investors of an STS status being removed from one of their investment could be very substantial. At the same time, if a single one of the multiple STS criteria, including the homogeneity criterion, is found not to have been met, the law requires the STS status to be removed. It follows that without a materiality threshold, the discovery of a single loan in a fifteen thousand loan securitisation that accidentally slipped through the originator's due diligence process would potentially lead to the removal of that securitisation's STS status and trigger extreme consequences out of all proportion to the problem.

A fragile STS regime subject to such hair-triggers is not sensible nor likely to be very successful.

Also, a sensible regulatory scheme should be able to balance the prudential needs of the system with the cost and difficulties imposed on market participants. Loan origination is a complex process where many commercial, credit and other aspects need to be balanced. To require originators to sift through their loan books to craft absolutely homogenous pools by weeding out a few outliers could, in many cases, be burdensome and costly. However, from an investor side, so long as the relevant information is disclosed, it is usually extremely easy to set aside a very small portion of the pool that you may either analyse differently or, more likely, simply ignore by assuming the worse. Therefore, the absence of a materiality threshold seems to create a disproportionate cost for a negligeable prudential benefit.

For those two reasons, PCS believes a materiality threshold is essential and agrees that 5% feels like a reasonable number.

Q15: Alternatively, do you see merit in introducing synergies with IRB modelling, enabling the IRB banks to rely on risk management factors validated for modelling purposes, when assessing the similarity of the underwriting standards, or assessing relevant risk factors? Please provide the reasoning and examples for possible introduction of such synergies.

PCS believes this is an extremely bad idea.

The homogeneity criteria is designed to assist capital market investors, most of which – it is hoped - will be non-banks, to analyse the securitised assets with a single methodology. The IRB modeling is designed for a totally different purpose and for a totally different actor with tools unlikely to be available to any non-bank or less sophisticated bank investor.

To introduce this approach would be tantamount to saying to investors that a pool is homogeneous not because the investor can model it using a single methodology at his or her disposal but because the originator could have done so but only with tools that are not available to that investor. This shifts the focus of this criterion away from the investor for which it was created to the originator. As such it is not faithful to the intent of the criterion or, for that matter, the whole STS regime.

Q16. Which option from the two (the existing proposal as described in this consultation paper, and the alternative option as described in this box) is considered more appropriate and provides more clarity and certainty on the determination of homogeneity? Please substantiate your reasoning.

PCS agrees with the EBA's basic approach that homogeneity should be focused on the investors' capacity to analyse properly an asset pool using a single methodological approach.

The first approach, by providing four objective categories, achieves this focus. An approach that intertwines underwriting and risk factors shifts the focus back away from the investor to the originator. As with the proposal in Question 15, it opens up the possibility of identical transaction being treated differently based on actions of the originator rather than the objective nature of the pool.

From an originator point of view – especially for assets originated before 2018/2019 – it raises the prospect of trying to fit retrospectively underwriting practices into a set of rules passed at a later date and for different purposes. It also raises the prospect that they will fail – even if the pools are objectively homogenous.

PCS strongly supports the first option.

Q17: Please provide an assessment of the impact of the two proposed options, on your existing securitisation practices and if possible, provide examples of impact on existing transactions.

PCS does not issue or invest in securitisations.

Q18. Alternatively, do you believe that a hybrid option, combining the existing proposal and the alternative proposal, would be most appropriate? The hybrid option could envisage that all the risk factors would need to be taken into account in the underwriting, and for those risk factors that are not taken into account in the underwriting, (i) either adequate justification would need to be provided that it is not required for the purpose of the homogeneity, (ii) or if the justification cannot be provided, the risk factor would still need to be taken into account when determining the exposures in the pool (on the top of the requirements related to underwriting, servicing, and asset category). Or, should other hybrid option be envisaged? Please substantiate your reasoning.

For reasons set out in our response to Question 16, PCS does not favour a hybrid option.

Q19. What are the advantages, disadvantages and unintended consequences of this alternative option, in particular compared to the existing proposal?

We refer back to our responses to Question 16.

Q20. Are there any impediments or practical implications of this alternative option as defined? Are there any important and severe unintended consequences of the application of this option?

We refer back to our responses to Question 16.

We hope this response may be helpful and stand ready to assist in any way that is deemed useful.

Faithfully

Prime Collateralised Securities 15th March, 2018