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25th November, 2019

Dear Sirs and Madams

Response to the Discussion Paper on Synthetic Securitisations

Introduction

PCS would like to thank the European Banking Authority for the opportunity to contribute to the debate on the value and the modalities of crafting a set of STS standards for synthetic securitisations.

As a general remark, PCS commends the EBA's approach in defining what the appropriate criteria should be for synthetic STS and agrees with the approach of basing such criteria on the existing "true sale" STS criteria. PCS also strongly believes that such definition should lead to a differentiated capital treatment both for reasons of logic, prudential appropriateness and macro-prudential and economic outcome.

General Comments

There are two comments of a general nature that PCS believes should guide any approach to the regulation of synthetic securitisations.

What is at stake?

The subject matter of the Discussion Paper may seem, even to those familiar with finance, to be somewhat obscure and technical. PCS believes that, when it comes to finance, this is potentially one of the most important files currently before policy makers in Europe and that the outcome of this process may have an impact disproportionate to its seeming technicality.

According to the EBA's own analysis[1], European banks will be required to increase their capital by almost 25% to meet the new Basel requirements. This number rises to almost 30% for globally systemic institutions. An even greater concern for those who worry about the current capacity of banks to finance growth and transformation in the European economy – including the transformation required by the European institutions' ambitions in the green space – is that these numbers are based on the conservative assumption that banks' balance sheets remain static.

Bearing in mind the oft stated statistic that 75% of Europe's financial needs are met by bank funding, there is an artificial ceiling on the financing of the European economy based on the capacity of banks to raise capital. We write "artificial" because the limits on the banks' capacity for raising capital are not necessarily and logically connected either to the health of the overall European economy or to its legitimate financial needs. Banks may find the raising of capital difficult because of concerns over the returns that may be available to equity investors compared to both the inherent risk and the alternative sources of equity risk available to such investors. This may be true even at a time when the European economy is in need of the financial resources to power growth and innovation.

In the next few years, we will likely witness the coming together of two sources of pressure on banks' lending capacity. First, banks will have to raise 25% to 30% more capital *merely to maintain current lending.* Secondly, the current ultra-low interest rate environment driven by central bank monetary policy drives spread-compression on the one hand and turns, in many cases, retail deposits not into a source of strength for banks but a further drag on profits. Both lower banks' profitability and will raise question marks over their attractiveness to equity investors.

If banks become constrained in the amount of capital they can raise, in the absence of any tools to recycle legitimately their capital resources, they will have no choice but to contract lending. This could have a very serious impact on the capacity of the European economy not only to compete internationally but also to fulfil the ambitious ESG goals that policy makers seek to set for the continent.

PCS, together with many other market participants, has long maintained that the crucial value of a properly regulated securitisation market is its capacity to allow banks legitimately to recycle capital by genuinely moving the credit risk of existing lending off one's regulatory balance sheet[2].

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[1] EBA Basel assessment sees impact driven by large banks - July 2019
https://eba.europa.eu/eba-basel-assessment-sees-impact-driven-by-large-banks
[2] Europe in Transition – Bridging the Funding Gap - March 2103
https://pcsmarket.org/draft//wp-content/uploads/2013/03/Europe-in-Transition-Bridging-the-Funding-Gap1.pdf+

When examining the issues around synthetic STS securitisations, PCS understands the need to ensure the stability of the financial system. In particular, PCS has always opposed the use of prudential rules to encourage specific political outcomes. The goal of prudential rules must always be to ensure the integrity of the European financial system. But the prudential rules must be fair and evidence based. When one looks at the risks to the European economy from a lack of financial capacity due to bank capital constraints it is clear that there are consequences to an excessively lax regulatory framework but there are also consequences to one that is unjustifiably too strict.

Bearing in mind the European economy's very likely need for tools allowing banks legitimately to recycle capital, these should not be ruled out or constrained unless this is essential to maintaining the financial stability of the region. Synthetic securitisation is such a tool.

Returning therefore to the subject of this consultation, PCS strongly believes that what is at stake in the crafting of a set of synthetic STS rules is not merely a technocratic adjustment to the capital requirement framework but potentially a key answer to the challenges that may face the European economy. We urge regulators and policy makers, bearing in mind the consequences, not to default to a "conservatism for conservatism's sake" approach but to seek a fair balance between financial prudence and financial needs.

SRT and STS

The EBA correctly points out in the Discussion Paper that synthetic securitisation is used primarily by banks to manage their regulatory capital positions. They further point out, equally correctly, that the senior positions in synthetic securitisations are usually held by the protection buyers whilst only the junior and/or mezzanine tranches are sold to sophisticated investors. The EBA finally remarks that most of these investors are not banks or insurance undertakings and so would not seek or obtain any capital benefit for their holdings in synthetic securitisations.

The EBA seems to conclude from this that, since synthetic securitisations are used to reduce capital requirements on the securitised assets, the proposed synthetic rules should be as concerned in ensuring proper significant risk transfer (SRT) for the protection buyer as in the creation of a simple, transparent and standardised (STS) securitisation for the investor.

As a general matter, PCS draw attention to the fact that the new rules are for current but also future markets and should therefore be principles based.

In this regard, we note the following:

a) The fact that synthetic securitisation is currently used banks for SRT purposes does not mean that non-banks may not use the technology. One cannot forget that the development of non-bank financial intermediaries is welcomed by policy makers.

b) The fact that synthetic securitisation is currently used mainly for SRT purposes does not mean that banks and, even more obviously, non-banks may not use the technology for the management of risk and economic capital. Such use is entirely legitimate and probably very welcome from a financial stability point of view. PCS is indeed aware that this is already taking place.

c) The fact that investors in synthetic securitisations are currently mainly neither banks or insurance companies does not mean that this will remain the case.

d) The fact that investors currently invest in the junior or mezzanine parts of synthetic securitisations does not mean that this will continue to be the case. In the past, so-called "super-senior" positions in synthetic securitisation were sold, often to insurance undertakings.

STS is an investor protection standard. PCS therefore is concerned that the Discussion Paper seems to introduce requirements that seek to ensure SRT treatment even at the cost of making STS securitisation less simple or less transparent or less standardised.

Although we see no principled justification for the introduction of SRT requirements in an investor protection standard, PCS acknowledges that it is probably of no great consequence in those cases where these requirements have little impact on the investors' position. However, and bearing in mind points a) to d) above, we urge the EBA not to impose STS criteria for synthetics that clearly make such securitisations markedly worse for investors than they need to be. We remind the EBA that these rules will also apply to transactions that will not seek SRT, so that – in such circumstances – this worsening of the position of investors is without justification. This is especially true in circumstances where the CRR rules already have provisions accounting for the risk that the proposed synthetic STS criteria seek to remove. In those cases, if a synthetic securitisation were to contain such risks, the CRR rules would allocate capital against these anyway and thus prevent any weakening of the overall prudential framework.

PCS will, in this response, draw the EBA's attention to those proposed criteria flowing from SRT considerations where we believe there is little or no justification for the criterion in STS.

Question 1: Do you have any comments on this introductory section of the Discussion Paper?

PCS broadly agrees with the comments in the introductory section of the Discussion Paper.

In particular, PCS fully supports the distinction between arbitrage synthetic securitisations and balance sheet synthetic securitisations. As with originate-to-distribute true sale securitisations, PCS believes that there are fundamental misalignments of interest in arbitrage securitisations and that these inherently push these transactions towards difficult to quantify risk. In the absence of any discernible benefit to the real economy of such arbitrage products, PCS sees little to no benefit in seeking to incorporate them into an STS regime.

PCS would make one remark on the comment in paragraph 10 regarding the concept of “more appropriate levels of non-neutrality of capital charges [for STS securitisations]”. PCS has argued previously that, so far as we can tell, the STS regime for true sale securitisations removes all the identified sources for this non-neutrality. Although we are well aware that this battle may have been lost in the recent amendment to the CRR, we would not wish the EBA to conclude that we do not still hold this to be the case or that we believe there are any rational grounds for holding that the current levels of non-neutrality for STS securitisations are justified by the data or the analysis.

Question 2: Do you agree with the analysis on the market developments? Please provide any additional relevant information to complement the analysis.

PCS has no comments on this analysis. The data is consistent with our own understanding of the market.

Question 3: Do you agree with the analysis of the historical performance? Please provide any additional relevant information to complement the analysis.

PCS has no issues with the analysis of historical performance contained in the Discussion Paper.

We would provide not so much additional information as a general comment. PCS acknowledges that the data set for synthetic securitisations is smaller than that for true sale securitisations. When approaching this relative lack of data we would therefore seek to interrogate the data on a principled basis and enquire whether there are any grounds for believing that the smaller data set should not be trusted.

The data would indicate that balance sheet synthetic securitisations have displayed the same credit outcomes as similarly rated true sale securitisations. The aim of a securitisation is to transfer to investors the risk of a given pool of assets on a tranched basis. If the transaction is properly structured, for example in line with STS principles, broadly only the risks of the assets should be passed on to investors. This is the case for both synthetic and true sale securitisations. Therefore, any difference between the performance of the two sets – absent identified rating agency distinctions in methodology – should be either (i) as a result of adverse selection in the pools of either synthetic or true sale transactions or (ii) an aspect of the nature of risk transfer under a synthetic transaction that modified the risk associated with such transactions when compared to true sale securitisations. Taking into consideration the amount of data provided to investors in both types of securitisations as well as the regulatory requirements of SRT, the first (adverse selection) is highly unlikely. As for the second, PCS has not identified any structural difference that would make a difference in credit outcomes – with the exception of funded transactions where the cash is held with the protection buyer and where insolvency of the protection buyer could result in a worse outcome for investors.

In the absence of protection buyers' insolvencies in the data, there is therefore, in our opinion, no reason to doubt the information provided by the admittedly smaller data set relating to synthetic securitisations – namely that they perform in line with true sale securitisations.

This is not, of course, dispositive and a smaller data set is always an issue. There are always the problems associated with "the unknown unknowns". But a principled analysis as set out above should give some additional comfort when gauging one's capacity for reliance on the data.

Question 4: Do you agree with the analysis of the rationale for the creation of the STS synthetic instrument? How useful and necessary is synthetic securitisation for the originator and the investor? What are the possible hurdles for further development of the market?

PCS strongly agrees that the analysis fully justifies the creation of an STS synthetic instrument and with the general conclusions of paragraph 78.

In particular, we agree with the comments in paragraph 62 on the overall regulatory framework for securitisation especially as it pertains to transparency and proper risk retention rules as well as the comments in paragraph 64 on the availability of data.

PCS confirms the views expressed in paragraph 66 as to the trend towards increasing standardisation in the synthetic market. In 2018, PCS set itself the task to craft a set of criteria for its "Risk Transfer Label" which may be granted to synthetic securitisations meeting certain quality standards. For the exercise, PCS gathered together a working group that included protection buyers (both from the public and the private sector), protection sellers and law firms working in the field. Following extensive discussions, PCS was able to conclude that what is often perceived as the lack of homogeneity in the synthetic securitisation market was superficial. We discovered that one of the reasons for the appearance of lack of standardisation is the various different legal structures used to effect synthetic securitisations. Some transactions are effected by a derivative instrument, other by the issue of securities; some by the use of a special purpose vehicle, other not. Some involved the use of collateral, others did not. This diversity is in clear contrast to true sale securitisations where the invariable contractual framework is the sale for cash of assets to an SPE that issues debt securities.

However, when we discussed with the working group the fundamentals of risk transfer as well as the management of specific risks (eg, the definition of credit events, the handling of currency and basis risk, the calculation of loss and the use of verification agents), PCS discovered that there was broad agreement amongst all market participants as to how these were handled. Some items were subject to alternative approaches depending on the risk appetite of protections sellers and the needs of protection buyers. But even in those cases, there were usually two alternative approaches, not a multitude.

PCS was also able to conclude in respect of its own label that the required task did not involve the creation of a new standard as much as the codification of an existing standard of quality. This is similar to the process that saw the creation of a true sale STS definition. Taking into account the extremely good credit performance of true sale securitisations in Europe in traditional asset classes, STS became justifiably an exercise in codifying existing good practice. In our opinion, the existing level of standardisation and equally good performance of balance sheet synthetic securitisations in Europe makes the two exercises similar.

This last consideration is one of the reasons why PCS is also strongly in agreement with paragraph 68 on the relevance of an STS regulatory framework.

With regards to paragraph 71, we draw the EBA's attention to our introductory comments on page 2 (*"SRT and STS"*). We agree with the comments relating to the manner in which different structures will alter the balance of risk between the originator and the investor, but – as set out on page 2 – we do not believe that an investor standard should be used to punish investors when the SRT issues are already handled by existing CRR rules (eg counterparty risk).

With regards to paragraph 72, we agree that synthetic securitisations are easier to effect than true sale. But we also note that regulatory capital relief is not the only driver of securitisations. True sale securitisations also produce nonreturnable funding. Also, the universe of senior tranche securitisation investors and the amount of money they may deploy is considerably larger than that of synthetic mezzanine investors. The two investor bases are also different. Not all investors able to invest in true sale securities are able to invest in credit protection trades. Finally, as the EBA recognises in paragraph 74, synthetic securitisations retain a level of originator risk as to the payment of premia and, in funded transactions, the collateral. Therefore, the ease of structuring and documenting does not mean that synthetic securitisation will be invariably the choice of originators or will "cannibalise" the true sale market.

Pros

PCS agrees with the all the pros set out in the Discussion Paper.

80. *Increased transparency and 83 standardisation*:

PCS sees both of these as complementary aspects of the introduction of an STS standard for synthetic securitisations. These arguments exactly parallel those made during the discussions that led to the creation of a true sale STS regime. All the reasons justifying the adoption of the latter apply to the creation of a synthetic STS regime. It creates a benchmark on simplicity and transparency leading to increase standardisation around a common core. As with the true sale STS rules, synthetic STS rules would not (nor would they seek to) address credit quality. But they would address the capacity of investor to achieve confidence in their capacity to analyse the relevant credit risk. This, in turn, can lead to new investors having the confidence to enter into this market, freed from the stigma inherited from the crisis of 2007-2008 and from the damage suffered during that time from badly constructed, opaque arbitrage synthetics.

PCS has no wish to rehearse all the reasons that led to the creation of a successful true sale STS regime but simply points out that if these arguments were persuasive in respect of true sale STS, we see no reason why they do not equally apply to synthetics.

81. *Increased relevance of the product in the context of current regulatory developments* and 85 *positive impact on markets and real economy*:

We refer you back to our introductory remarks as to the vital importance of developing this market (*"What is at stake?"*). But PCS acknowledges that if synthetic securitisation should play such a role, it is in all stakeholders' interest that a regime of rules be put in place to underpin solidity and transparency as well as encouraging standardisation.

We also commend the acknowledgement in sub-paragraph b. that all synthetic securitisations are not necessarily about CRR capital adequacy and may indeed be used to address risk and economic capital issues. This though, as we point out in our introductory remarks (*"SRT and STS"*), has consequences in the drafting of synthetic STS criteria.

82. *Advantages compared to traditional securitisation*:

We agree with the comments in the Discussion Paper. In addition, synthetic securitisation has advantages over traditional asset classes which go beyond protection of confidentiality.

Synthetic securitisation allows the transfer of risk over assets which contain prohibitions on disposal. This is not uncommon in loans to larger corporates.

It also allows the securitisation of assets in jurisdictions where a sale requires notification to the underlying borrower and such notification would be highly detrimental in reputational terms.

It also allows securitisations where a true sale would trigger or may trigger adverse tax consequences. This was the reason why, originally, most German securitisations were done in a synthetic form.

It also allows securitisations where the investors cannot or may not wish to fund the entire face value of the pool. For example, insurance companies may be willing to write protection but not to fund.

84. *Regulatory endorsement:*

We agree with the comments in the Discussion Paper

Cons

86. *Not a global standard*

PCS acknowledges this fact but would make a number of comments in this regard.

First, this was also the case for the true sale STS regime. Even though Basel did produce an STC standard technically before the finalisation of the European STS regime, the historical reality is that Europe elected to forge ahead with its own standard in the teeth of strenuous opposition by the Basel Committee. It is only Europe's insistence on designing a successful STS standard that led Basel (together with IOSCO) to follow suit. If this approach was legitimate for true sale STS, there is no reason why it would not be for synthetic securitisation. This is once more an opportunity for Europe to lead in the field of global financial regulation.

Secondly, in the realm of securitisation, global standards have been eroded by all parties. The STC regime is optional within the Basel framework. The result is that it operates with capital benefits in Japan. It does not, and is unlikely ever, to operate in the United States. In Australia, it may operate in the near future but without capital benefits. It does not operate in Europe where our own STS regime is substantially different.

In the United States, no retention is required for most RMBS transactions and, admittedly as the result of a challenge before the courts, for CLOs and CDOs.

Covered bonds receive a better treatment in the EU than they do in the United States.

The desirability of global standards is not challenged. But the question must be raised when these have already disappeared from meaningful sections of the market, how much weight can realistically be ascribed to this argument.

Thirdly, global standards may be desirable but must be placed in the balance with local requirements and benefits. In our introductory remarks we pointed out that 75% of the financing of the economy in Europe is provided by banks. This is only 25% in the United States. It follows that the impact of capital constraints on banks for the overall economy is much smaller in the US. When one considers that, in the 25% of funding provided in the US by banks, a part is provided by the 90% of banks whose capital is still governed by Basel I, the impact of the increases contemplated by Basel III is further reduced. Finally, the US authorities may be less concerned by the success of the synthetic market in recycling capital when one considers that US banks have access to a massive government subsidised capital relief scheme in the GSEs (Fanny Mae, Ginny Mae and Freddy Mac).

PCS would therefore strongly argue, in view of the risks posed to the European economy outlined in our introductory remarks, that the development of a fully functioning but safe synthetic market via the creation of an STS regime should not be dependent on negotiations with other global players who may have no objective interest in endorsing one.

Fourthly, Europe is already operating an STS regime for true sale securitisation. By declining to extend that regime to equivalent synthetic securitisations, Europe would accept a disparate treatment within the European regulatory framework for effectively similar instruments.

In other words, to refuse to move ahead with a synthetic STS regime to remain within Basel would result in accepting an internally incoherent European regulatory regime to maintain part coherence with the Basel regime.

87. *Other concerns*

The issue of market confusion was raised, discussed and dismissed when the true sale STS regime was crafted. In view of the sophisticated nature of the investors in synthetic securitisations, purchasing as they do the mezzanine tranches, this argument seems even less convincing in the case of synthetic STS.

PCS would also challenge what we suspect is only a matter of wording in paragraph 87. The EBA writes of the moral hazard of investors considering that the STS Label “inherently means high quality product”. We would argue that securitisations meeting the STS criteria ***are*** inherently a high quality product. They are so because of the greater simplicity and structural features they possess. Otherwise, what would be the point. What STS securitisations

are not is inherently better credit risks. Credit is not the aspect STS seeks to address. We assume this was what the EBA had in mind, since there is little point in creating a two-tier system if one tier is not in some fashion superior to the other.

With regard to synthetic securitisations leading to less true sale securitisations, it is very difficult to predict. However, in our response to paragraph 72, we point out to the benefits that the latter has over the former. On balance, with the appropriate capital requirements attaching to both forms of STS securitisations, we feel the risk of fewer true sale securitisation resulting from the growth of synthetic securitisation to any meaningful extent is low. PCS would rather hope that both sets of issuance would increase. Our discussions with originators indicate that our views on this are shared by the banks.

How useful and necessary is synthetic securitisation for the originator and the investor?

We would refer back to our introductory comments ("*What is at stake?*").

What are the possible hurdles for further development of the market?

The analysis of whether a transaction is STS is a complex one. It is also an exercise that is distinct from the credit analysis. Although many aspects appear to overlap, the STS criteria are compliance criteria not credit criteria. For example, whether an investor considers a pool to contain credit impaired borrowers is an individual investor's credit opinion grounded in that investor's perception of the risks associated with specific impairment elements. But whether the same pool contains "credit impaired borrowers" for the purposes of STS is a legal and compliance question dependent on the legal definition of that expression in the level 1 STS Regulation and various sources of level 2 legislation and level 3 guidelines.

Therefore, the creation of a complex STS definition associated with meaningful negative consequence in cases where the analysis is wrongly conducted raises a due diligence challenge.

This due diligence challenge is heightened in the case of most synthetics because they are private and often bi-lateral trades. Therefore, they do not have the benefit of multiple sets of eyes all looking at the same data as you have in a publicly placed true sale securitisations. This is not improved by the fact that these transactions are often unrated.

In addition, for individual investors, assuming that article 5.3 of the current STS Regulation stands in respect of synthetic securitisations, this is a weighty additional burden that might well lead them away from purchasing the product.

Finally, if - as PCS strongly believes should be the case - a differentiated capital regime is put in place for synthetic securitisations, the challenge of confirming to their own satisfaction that a transaction really is STS will then fall on the regulatory community.

In the case of the current STS regime for true sale securitisations, these issues have been, to a large extent, addressed by the creation of regulated third party verification agents. Obviously, PCS is one such agent. This has worked extremely well to date and virtually all STS true sale securitisations (including all those placed with investors) have been verified.

Failure to extend the work of regulated third party verification agents to synthetic STS securitisations would be a meaningful hurdle for further development of the market. Although the EBA may consider the issue "out-of-scope" for its report to the European Commission, PCS would strongly suggest that a short paragraph drawing attention to the benefit of so extending the third-party verification regime could save a lot of discussions further down the line.

Question 5: Do you agree with the assessment of the reasons that could eventually support a preferential capital treatment?

PCS strongly agrees with the reasons that militate for an improved capital treatment for synthetic securitisations meeting the STS standard. We will seek to avoid the expression "preferential capital treatment" as it may lead some readers to believe that what is being proposed is an unwarranted and illegitimate preference awarded to a politically favoured asset class. We would respectfully suggest that "appropriately differentiated capital treatment" may better reflect the subject matter at hand.

Pros

The debate around true sale STS standards was based both on data and a principled analysis. The data showed that all securitisations had not performed equally during the crisis and that certain types demonstrated, in fact, extremely positive credit outcomes. The principled analysis, set out in EBA's important paper on Qualifying Securitisations of July 2015, identified the elements that had led to this starkly differentiated outcome. These elements formed the basis of the STS standards.

In respect of synthetic securitisations, the data shows the same deeply bifurcated sets of credit outcomes based on whether the securitisations were arbitrage or balance sheet transactions. A read of the principles underpinning the good performance of STS true sale securitisations as set out in the EBA's paper will quickly demonstrate that they are of equal applicability to synthetic transactions.

These include avoidance of misalignment of interest embedded in the originate to distribute model, the hallmark of synthetic arbitrage trades.

They also include the avoidance of iterative credit tranching, found in the most egregious arbitrage CDO's.

They include avoiding reliance on refinancing of the asset to repay the securitisation.

Finally, they point to the need for transparency, now dealt with by article 7 of the STS Regulation.

All these sources of strength apply equally to synthetic trades and the data supports this assertion.

PCS is not able to identify any specific additional risks unique to synthetics and which may be demonstrated to have played a role during the crisis in the sub-par performance of some types of synthetic securitisations.

Therefore, the extension of differentiated capital charges for synthetic STS transactions, bringing them in line with the charges for true sale STS transactions, is consistent with the data and with the principled analysis that was conducted by the EBA for the creation of the true sale STS regime and cannot logically be differentiated for synthetics.

In PCS' view, the question is not whether synthetic STS securitisations should carry the same capital requirements as true sale STS securitisation but rather what possible rationale can be adduced not to do so? The data supports such an outcome. The principled analysis supports such an outcome.

Absent this alignment between the two types of STS securitisations, the capital regime will become incoherent, treating the same risk differently depending on the legal form that risk takes. This is not only illogical but creates perverse incentives which prudential frameworks traditionally seek to avoid.

So PCS agrees with the comments in paragraphs 89 and 91 and recognises the comment in paragraph 90 that article 270 of the CRR already acknowledges these realities and that it would be anomalous to retain capital benefit solely for one type of synthetic securitisations – namely SMEs.

Although we agree with paragraph 92, that a better capital treatment would improve usage of synthetic securitisation which PCS believes to be a good thing, PCS has always warned against using prudential regulations to achieve macro-economic outcomes by skewing the capital regime away from alignment with the actual risk. We have drawn attention to the importance of synthetic securitisation in our introductory comments ("*What is at stake?*") to highlight the importance of the debate and forestall an overly conservative approach that fails to account for the costs of not doing the right thing. However, we believe that prudential rules should reflect actual risk. So we do not agree that helping synthetic securitisation is a good reason to modify the capital treatment.

However, as stated above, we believe that aligning the capital requirements for synthetic STS securitisation with that of true sale STS securitisation is nevertheless the technically correct approach.

Cons

Basel non-compliance

We refer you to our comments on paragraph 86.

Potential risks for the banking sector

Although the word "opportunistic" has negative connotations, it is not entirely clear to us why this is in the "Con" column. As we have set out in our introductory comments, the great systemic benefit of securitisation is that it allows banks legitimately to remove risk from their regulatory balance sheet (provided all appropriate SRT rules are followed). This, in turn, allows banks to recycle existing capital to make new lending. The last element breaks the artificial link between the amount of finance required by the economy and the capacity of banks to raise capital.

In other words, an "increase [in] the motivation for banks to engage in securitisation for capital benefit" is a positive development for the European economy.

As for the "potentially […] negative impact on the stability of the bank", PCS is not clear as to how this would materialise. Assuming all the SRT rules have been fully met, the bank no longer has the now securitised risk for which capital was required. So the bank remains adequately capitalised. PCS agrees that leverage would be increased but is not sure why leverage without attendant risk is a concern for the stability of banks and how, precisely, this lack of stability would present in a crisis. Without a more detailed scenario analysis PCS finds it difficult to gauge to what extent, or even whether, a problem has been identified at all.

Question 6: Please provide any additional relevant information on potential impact of the creation of the STS synthetic securitisation on (STS) traditional securitisation, and any other information to complement the analysis.

PCS does not have any additional relevant information on this matter.

Question 7: Do you agree with the criteria on simplicity? Please provide comments on their technical applicability and relevance for synthetic securitisation.

Criterion 1

PCS does not understand the rationale for strictly limiting the types of protection buyer as set out in paragraph 2. There are lenders in the European space that are not prudentially regulated institutions. Some may be the subsidiaries of prudentially regulated institutions, others may be stand-alone financial businesses. PCS notes that the thrust of current policy makers is to encourage such non-bank lenders especially in the fintech sector. This reflects, as we understand, a desire both to decrease reliance on "too-big-to-fail" banks and foster efficiencies and competition. We also note that such institutions may well wish to use synthetic securitisations not – since they are not prudentially regulated – to reduce Basel capital but prudently to manage credit risk and economic capital use.

Since one presumes it is the intention of the regulators and policy makers to make synthetic STS a benchmark product and a new, high quality asset class, it is unfair on such institutions arbitrarily to deny them access to this market even when they meet all the criteria for simplicity, transparency and standardisation. It will also encourage potentially a thriving high-quality synthetic securitisation market that is not STS because in cannot be STS. This would undermine the desire for standardisation in this market.

Assuming that differentiated capital requirements are introduced and extend to insurance companies under a revised Solvency II calibration, should insurance companies wish to underwrite risk in the financial sector via synthetic securitisations (including arguably the purchase of senior tranches of risk), this would effectively close off access to this market to all non-bank protection buyers.

If the rationale is to avoid special purpose entities similar to the failed structured investment vehicles, set up for the sole purpose of originating loans in the secondary market rather than being primary lenders to the real economy, PCS would indeed support such limitation. However, such limitation would be more rationally achieved by tightening the definition of "special purpose vehicle" in Criterion 7 than in this current Criterion 1 prohibition and/or requiring originators to be authorised and subject to a regulatory regime concerned with lending such as consumer lending licenses and similar licenses. This should be sufficient to rule out capital market arbitrage type players. (We also note that the prohibition on the securitised assets being securities naturally reduces the scope for SIV style players in this field anyway.)

As no rationale is presented in the Discussion Paper, PCS is not sure this is the reason for this proposal. However, it appears to us arbitrary, discriminatory and unfair as well as potentially undermining the general intent behind the concept of an STS quality market.

PCS is also not supportive of the requirement that STS securitisation need to meet the SRT rules. We refer to our introductory comments ("*SRT and STS*"). In particular, we note that synthetic securitisations may be and have been used by banks to manage risk and economic capital usage. If this is done via a synthetic securitisation that meets all the investor requirements of simplicity, transparency and standardisation PCS fails to see why such high-quality instruments should be denied the STS status which their inherent qualities justify because the protection buyer does meet or seek to meet the SRT rules. Equally, it is not clear what the justification would be to force the protection buyer to meet a whole series of rules to be able to place STS securitisation when it does not need nor seek capital relief.

The regulator has SRT rules and these are important to capital relief. But PCS cannot support their arbitrary imposition to an investor protection standard. PCS also does not understand why this would be necessary or even welcome. If a regulated protection buyer sells a high-quality synthetic securitisation but fails to meet all the SRT rules, then it will not obtain any capital relief. This is all the protection that the regulator requires. Why force this on an investor who derives no benefit nor seeks the benefit of these SRT rules.

PCS also notes that this approach is inconsistent with the true sale STS standard. Even though it is entirely possible to use a true sale securitisation for SRT purposes ("full-stack deals"), nowhere is meeting the SRT rules a requirement of obtaining STS status for a true sale securitisation.

The requirement of "equivalently robust requirements in case the protection buyer is not an institution regulated under the CRR" is even more puzzling. Why would the STS criteria that seek to protect investors require that investors take *additional* risk to meet risk transfer standards for which the protection buyer has absolutely no use?

Also it is not clear how an originator, investor or third party verification agent would begin to determine whether the "requirements" were more robust. What does "requirement" even mean in this context? Assuming the originator is regulated, does this provision mean that it can never achieve STS if its own regulator has not adopted some type of risk transfer rules? If it is not regulated or its regulator has no "requirements", what could be "requirements" – accounting standards? And even if they are requirements, how does one assess that they are equally "robust". PCS believes, based on its current work of verification of STS securitisations, that this criterion, as currently envisaged, is unworkable.

PCS strongly supports the requirement that the exposures should be on the balance sheet of the protection buyer to avoid arbitrage securitisations being STS. We would recommend though that the rules allow that they should be on the balance sheet of the protection buyer or a member of that protection buyer's group. This may be required to avoid technical issues relating to the application of the laws governing insurance. Also, for prudentially regulated institutions, we suggest that "balance sheet" should be interpreted as "regulatory balance sheet". Ultimately, this is the balance sheet that is relevant for such institutions and it will avoid quirks in accounting principles or changes in accounting treatment having a negative and unnecessary impact on what may be STS.

PCS is supportive of the notion of exposures being part of "core lending or any other core business activity" but notes that these expressions will need, at some point, to be fleshed out. Otherwise, we anticipate a great deal of potential regulatory uncertainty over this point.

PCS also strongly supports the prohibition against double-hedging.

Criterion 2

PCS has only three comments on this criterion.

First, the title representation should provide that title is either with the protection buyer or a member of the protection buyer's group, lest the securitisation breach the legal limitations on insurance business.

Secondly, the representation on legal valid and binding should be to the "best of the knowledge" of the protection buyer. They are reasons why a contract may not be binding of which the protection buyer may legitimately not be aware eg. fraud, lack of mental capacity on the part of the borrower, violation of third-party contractual terms by the corporate borrower, etc…

Thirdly, the same point as above should apply to the "no untrue information" representation.

Criterion 3

PCS agrees with the general prohibition on active portfolio management.

We note though that in the PCS Risk Transfer Label criteria, it is allowable to remove exposures when:

a) the protection buyer has disposed on its interest in such exposure to an entity which is not an affiliate; and

b) the amount of regulatory capital that would otherwise have had to be held against the exposure increased.

Both of these grounds for "buy-back" appear to us to be legitimate and not indicative of active portfolio management. Our interpretation here is also consistent with the interpretation of "active portfolio management" in the guidelines published by the EBA in respect of true sale STS securitisations under the STS Regulation.

We would have no issue with additional wording around the disposal of exposures to ensure that such disposal is in the ordinary course of business and not a positive or negative "cherry picking" exercise in relation to a specific synthetic securitisation.

Criterion 4

Assuming that the rules on homogeneity are the same as or very similar to those appearing in the Homogeneity RTS under the STS Regulation, we have no comment on this criterion.

Criteria 5 and 6

No comments

Criterion 7

No comment save that the exclusion of special purpose entities could be problematic for the securitisation of project finance exposures. Since the capacity to remove project finance risk from banks should be welcomed, PCS would suggest making an exception for project finance exposures.

In addition, and in line with our comments on Criterion 1 regarding allowing unregulated originators, the EBA may wish to include in the definition of special purpose entities, entities set up for the sole purpose of originating assets in the secondary market to be securitised whether by means of true sale securitisations or synthetic securitisations.

Criteria 8 to 11

No comments

Criterion 12

PCS acknowledges that this is the same criterion as for true sale STS but one asset class where this might be modified is for large corporates where the protection buyer has an ongoing relationship including multiple payments on other facilities. PCS realises that this comment equally applies to true sale STS and should theoretically also be modified in the existing rules. However, as a level 1 issue, we acknowledge that this is not currently practical. We also note that large corporate exposures are very seldom the subject of true sale securitisations. So, in practice, this lacuna has little to no impact on the current STS rules. But it may have a greater impact on synthetics.

Criteria 13 and 14

No comment.

Criterion 15

PCS strongly disagrees with the imposition of a criterion requiring any currency or basis risk *borne by the protection buyer* to be eliminated.

We note that this is a higher standard that is required for the handling of such risk in true sale STS criteria ***when borne by the investor/protection seller*** where such risk is only to be appropriately mitigated, and this even though STS is an investor protection standard.

We further note that this appears to be solely an SRT consideration. We refer you back to our introductory comment ("*SRT and STS*") and more specifically to the remarks on situations where current CRR rules already provide regulatory protection from the relevant risk.

In the vast majority of securitisations with multiple currencies, the rate or rates at which currency translations are made is fixed at the outset. In some cases, there are provisions by which the rates may be modified but only when this modification does not increase the liability of the protection seller.

To remove all currency or basis risk from the protection buyer either requires the risk to fall on the protection seller or the insertion of a ***perfect*** hedge provided by a third party.

For the risk to fall on the protection seller is practically impossible as very few, if any, capital market investors would accept to invest in an instrument with an unpredictable principal. Even if an investor could be found for such an instrument, this would utterly violate the principles of simple, transparent and standardised and would directly contradict the true sale STS criteria that requires appropriate mitigation of such risk when borne *by the investor/protection seller*. Therefore, the transfer of such risk to the protection seller is clearly incompatible with STS status for such an instrument.

If the risk does not fall on the protection seller, it will have to be provided by a third party. Since *all* the risk must be removed, whatever hedging is put in place will also have to be a perfect hedge. Practically, the nature of such swap options and the unpredictability of the amounts at stake would render these instruments extremely costly if not impossible to obtain.

But PCS fails to understand why this would even be a requirement. PCS understands that the CRR already contains provisions accounting for currency and basis risk. If the existence of currency or basis risk requires and adjustment to any capital relief generated by the synthetic securitisation, there are mechanism for doing so.

Additionally, when calculating capital for such risks, banks will often have global hedges in place.

Therefore, whilst such a requirement would likely prevent most, if not all, multi-currency synthetic transactions from being STS it would provide no prudential benefit that was not already available within the CRR rules on the SRT side of the ledger.

Criterion 16

The EBA correctly notes that this is not really relevant for synthetic transactions on the asset side. It also notes that the provision of *information* on the securitised assets' interest rates might be useful. Although we agree that it might be useful, we also note that the proposed requirement is not one of information but a prohibition.

We therefore recommend that this criterion not apply to interest payments under the assets.

Criteria 17 and 18

No comment.

Criterion 19

PCS suspects this is mainly a drafting point, but we are not sure we understand the distinction made between the end of a revolving period and early amortisation where an SSPE is used.

Once the revolving period ends, no new assets are added. This automatically results in "early amortisation" since there is no cashflows to be trapped and therefore no way to halt the reduction of the protection amount when assets redeem. If the EBA means to refer to the return of collateral, this is already covered in Criterion 18.

The general principle is agreed though.

Criteria 20 and 21

No comment.

Criterion 22

It is clearly essential that a reference register be maintained and available to the protection sellers. However, it should be sufficient that the entries in the reference register be sufficient to identify without doubt the securitised exposures.

The requirement to identify the obligors by name, as this criterion suggests, would cause substantial confidentiality and GDPR issues. This is particularly acute in the consumer lending field.

We suggest the EBA clarify the criterion to indicate that this is not the requirement.

Criterion 23

No comment.

Question 9: Do you agree with the criteria on transparency? Please provide comments on their technical applicability and relevance for synthetic securitisation.

Criterion 26

Where no SSPE is used, it is not clear what a liability cash flow model would look like.

Although PCS has no objective to this criterion, we would suggest that it should probably only be applied where an SSPE is used.

Criteria 27 and 28

No comment

Question 10: Do you agree with the specific criteria for synthetic securitisation?

Criterion 29

No comment.

Criterion 30

Although interim payments are common in synthetic securitisation, we are not clear why these should be mandatory for STS to be obtained. Even from an SRT point of view, interim payments should not be relevant so long as the credit risk is fully mitigated. We would therefore recommend that there be no requirement for interim payments.

Even where interim payments are provided for in the transaction, we do not understand why their calculation should be as prescriptive as there are in the current draft.

This is not, we believe, particularly problematic. But STS is already a complex and highly prescriptive standard and we would urge the EBA not to add additional requirements whose purpose is unclear.

Also, PCS notes that the rights of the protection buyer to receive payments should be enforceable. This is unobjectionable. But, in an investor protection standard, it would behove the EBA at least to allow symmetry and require the payments due to the protection seller also to be enforceable.

Otherwise we agree with this criterion.

Criterion 31

PCS agrees that there should be a date on which a final protection payment must be made even when the workout of the defaulted asset has not been finalised. We are not sure that two years should be the mandatory period under the STS rules. Some assets may have longer average workout periods. Therefore, we would modify the criterion so that it requires a specified date after the scheduled maturity or termination of the securitisation and, to avoid abuse, that this date should not fall beyond five years of such maturity or termination.

Criterion 32

We do not understand what documentation is referred to in the second paragraph of this criterion.

Is this the documentation provided to the prospective protection seller?

As far as PCS is aware, synthetic securitisation are not priced by the protection buyer but by market negotiations between the parties who will take into account all the usual elements of capital market pricing – risk/return, current interest rate environments, relative pricing to similar instruments, liquidity (although rarely a feature in synthetic securitisation) and the protection seller's risk analysis, amongst other factors.

If this refers to documentation relating to how the protection buyer has priced the original offer in the market, such documentation would contain highly sensitive information never disclosed in any other capital market transaction to potential buyers.

Criterion 33

PCS notes that its own PCS Risk Transfer Label criteria also require the verification agent to ascertain that the protection buyer was in compliance at all times with the risk retention requirements.

Criterion 34

Although this is not an investor point, the market standard on regulatory calls is broader than that which is provided here. Any change that objectively results in a different capital treatment for the exposures is grounds for termination. It is not clear that the limits placed on regulatory calls in this criterion increase the simplicity or transparency of a synthetic securitisation and so may be better suited to an SRT rule outside of the STS regulations.

A similar comment applies to time calls.

This is probably a drafting point but, although this criterion speaks to the failure to pay premia by the protection buyer, it is only in relation to the protection buyer's right to terminate. We recommend that, in an investor protection standard, it is explicitly required in a separate criterion that the investor/protection seller must be entitled to terminate the protection in the event of a failure by the protection buyer to pay or meet material contractual obligations. PCS has no objections to providing that protection buyer insolvency, in and of itself, should not be a termination event.

Criterion 35

PCS does not agree that the incorporation of excess spread in a synthetic transaction is necessarily a complex feature. We also note that excess spread is available in all true sale securitisations and this does not prevent them from achieving STS status.

As with reference rates, we would suggest a criterion that requires a simple calculation of the amount of excess spread available to protection sellers so that complex calculations are removed from the STS standard.

Question 11: Do you agree with the criterion 36 on eligible credit protection agreement, counterparties and collateral? Please provide any relevant information on the type of credit protection and different collateral arrangements used in market practice and their pros and cons for the protection of the originator and investor.

Criterion 36

Unfunded securitisations

PCS strongly disagrees with the exclusion (for transactions not involving public entities) of unfunded transactions from the STS framework.

STS is a simplicity standard for securitisations. The essence of a securitisation is that the investor takes the tranched risk of an asset pool and does not have to analyse the credit of the originator or other third parties – save in a very ancillary manner, eg swap providers.

By requiring the entire principal of the securitisation to be funded, the STS standard will require investors to perform a double analysis: first on the credit of the pool and secondly on the credit of wherever the collateral is placed. To require this complexity when a much simpler structure exists, namely unfunded structures, goes against the foundational principles of STS. It is also entirely at odds with the rules for true sale STS where the investors do not have to perform a double credit analysis.

As far as we can tell, the sole purpose of requiring this additional complexity is to reduce the risk to the protection buyer. But the STS standard is an investor protection standard. Not a single true sale STS criterion seeks to lower the risk of the originator.

If this is an attempt to insert SRT requirements into the STS rules, we refer you back to our introductory comments ("*SRT and STS*"). This addition is also entirely unnecessary since CRR contains mechanisms to allocate appropriate capital in the case of unfunded synthetic securitisations. As the EBA is aware, in such circumstances, the credit risk of the protection seller is substituted for that of the pool of exposures. Therefore, it is never a question of having a risk for which no capital is allocated but only a variation in the amount of allocated capital to reflect the shift from asset risk to counterparty risk. Since there is no question of capital deficiency, PCS sees no justification even within the CRR/SRT perspective in requiring a more complex instrument to meet a simplicity standard.

In passing, we would also note that, even in the context of SRT, this imposition can lead to perverse results when the protection seller is an extremely highly rated institution and the collateral is placed in a bank with a lesser rating thus *increasing* the risk to the protection buyer.

Since many synthetic securitisations are funded PCS does not believe that they should be excluded from the STS standard.

Types of collateral

PCS believes the types of collateral provided in the draft criterion are too narrow. We note that PCS' own Risk Transfer Label also allows:

a) IFI securities

b) Senior secured obligations of EEA credit institutions (eg covered bonds)

c) Senior tranches of securitisations (which now should be senior tranches of STS securitisations and one could reasonably add a rating requirement)

d) Investments that are nominally and specifically agreed on a case by case basis during the life of the transaction by the protection buyer and the protection seller(s)

PCS believes all of these are compatible with a high standard of STS being simple and extremely transparent.

If these additional types of collateral causes an SRT issue, we would recommend that the prudential regulator take this into account in the prudential capital rules rather than the STS rules.

Haircuts

We note the requirement for haircuts in the collateral to account for mark-to-market risk. PCS is not entirely clear how the EBA sees this operating in practice, especially in transactions with no SSPE. Is the expectation that the protection sellers put up more cash than the principal amount of the tranche? Would the protection sellers be required to provide additional funding in case of adverse market movements in the value of the capital.

PCS would suggest – and believe this is market practice – that the methodological approach of the rating agencies be used. Namely, securities are purchased whose maturities broadly match the dates on which payments may be required so that there is never the requirement to sell securities in the secondary market. This would fully resolve an issue that the introduction of haircut merely seeks to mitigate.

Question 12: Please provide suggestions for any other specific criteria that should be introduced as part of the STS framework for simple, transparent and standardised securitisation.

Referring back to our comments on Criterion 15, we suggest that for securitisations involving an SSPE, it be a requirement of STS that any amount of interest or premia paid to protection sellers should be demonstrably equal to or smaller than the income received by the SSPE.

Question 13: Do you see a justification for possible introduction of a differentiated regulatory treatment of STS synthetic securitisation? If yes, what should be the scope of such treatment and how should it be structured - for example only for senior tranche retained by the originator bank, or more limited/wider?

PCS sees such introduction not only as justified but essential. See our introductory comments ("*What is at stake?*") and our response to Question 5.

As to the scope, PCS believes that it should match that of true sale STS securitisation. In other words, it should apply to all tranches, whether retained or sold and all types of regulated investors currently able to take the benefit of lower capital requirements for STS securitisations, namely banks and insurance undertakings under respectively the CRR and Solvency II.

The reason for this approach lies in both the purpose and the principles underpinning prudential capital regulation. PCS believes that the same risk should attract the same capital requirement. This is why we have never supported adjusting the prudential requirements to meet non-prudential goals. (See our answer to paragraph 92). By requiring different capital allocations to the same risk quanta, a prudential framework sets up potentially dangerously skewed incentives which usually weaken financial stability by pushing banks toward miscalibrated and under-capitalised activities.

Limiting the capital benefits of synthetic STS securitisations would produce this effect as can be demonstrated by simple examples.

If you limit the capital benefit to the senior tranche retained by the protection buyer, you create a situation where, if Bank A writes a synthetic and retains the senior tranche, it will require x% of capital to allocate against that position. But if Bank A, at a later stage, decides to sell its position as a super-senior to Bank B, then Bank B holding the exact same instrument will need to allocate a multiple of x%. Should Bank B then sell the position back to Bank A, the overall capital held in the financial system would fall again having risen on the first sale when absolutely no change has ever taken place to the overall amount of risk in the system.

Similarly, if you do not provide beneficial capital treatment to loss absorbing mezzanine tranches, you create a situation where an investor would require a% of capital to hold this risk in synthetic form but a much smaller amount of capital to hold exactly the same risk in true sale securitisation form (notwithstanding the added complexities of true sale securitisations such as the reliance on servicing and cash flows).

Unless a substantive and convincing reason can be adduced for introducing such distortions in the capital framework, we cannot see how it can be justified.

Question 14: What would be the impact if no differentiated regulatory treatment is introduced? In that case, is the introduction of the STS product without preferential treatment relevant for the market?

Based on our work as a third-party verification agent for true sale STS, we can attest that achieving STS status is not a simple task. It involves complexities with legal and structuring costs. At the same time, the investors in this market are highly sophisticated and unlikely to feel that they need such an external benchmark. If article 5.3 of the STS Regulation applies to synthetic STS securitisations, investors will conclude that STS is a burden with no benefit.

Without any benefit attached, PCS is fairly confident that no market participant will wish to go through this additional cost for a status no investor will be requesting. To be blunt, without differentiated regulatory capital treatment an STS status for synthetics is a waste of time and an important opportunity to break the dangerous link between bank capital and the financing of the real economy will have been lost.

Question 15: What would be the impact of potential differentiated regulatory treatment from level playing perspective with regard to third countries where STS framework has not been introduced?

We refer you to our response to paragraph 86. To summarise that part of our response, we believe that there is no level playing field in this area. We accept that focusing on the headline capital requirements may give the illusion of a level playing field. But if you look at the larger issue of the opportunities for financial institutions to recycle existing capital and generate new capital, Europe is at a clear disadvantage.

Question 16: Should a separate explicit recommendation be included in the Recommendations section on whether or not such treatment should be introduced?

Such recommendation is essential.

Conclusion

PCS is extremely supportive of the creation of a new regulatory regime for synthetic securitisations that parallels the STS regime put in place in 2017 for true sale securitisations.

Broadly we agree with the EBA’s approach and, in the specificities, we generally agree with the proposed criteria.

Our key concerns are first the introduction of SRT requirements in STS but only when (i) these materially damage the simplicity, transparency or standardisation of synthetic securitisation *and* (ii) are unnecessary because the existing CRR rules already provide remedies in the event that a synthetic securitisation does not contain the relevant features. Our second concern is the absence of capital benefits being proposed for synthetic STS securitisations.

We believe this absence to be unjustified either by the data or the analysis and probably fatal to any chance of success for this important project.

Yours faithfully

Ian Bell
Chief Executive Officer

On behalf of:

Prime Collateralised Securities (PCS) UK Limited and

Prime Collateralised Securities (PCS) EU sas