Setting the standard
for securitisation

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Dear Sirs and Madams

Response to the consultation on the draft triggers RTS

Prime Collateralised Securities (PCS) EU sas would like to thank the European Banking Authority for this opportunity to comment on this important technical aspect of on-balance-sheet securitisations.

I. INTRODUCTION

Prime Collateralised Securities (PCS) EU sas ("PCS") is an independent body authorised by the Autorité des Marchés Financiers in France as a third-party verification agent under the STS regime. In that capacity, PCS has already verified a number of STS on-balance-sheet securitisations. In addition, prior to the introduction of the STS on-balance-sheet category, PCS had worked with market participants and stakeholders (including the EBA) to set up a private synthetic securitisation quality label. The answers we provide here are grounded in that extensive knowledge of the subject-matter. The answers are also derived from our not-for-profit social purpose to assist in the growth of the European securitisation market on a safe and sound basis in an independent way and without representing any market participant or group of market participants. These views represent only our own and we do not write on behalf of our members or any other institution.

Based on our experience, most transactions contain pro rata to sequential amortization with a possible switch to sequential, as a key factor for the economic efficiency of the transaction. Therefore, such triggers are very important not only to originators and the ability to attain SRT but also to investors. The ability to maintain the originally agreed tranching as long as possible is seen as ensuring risk is transferred across time at the right price, in accordance with the risk perception of both investors and originators.

As it currently stands, transactions have often loosely interpreted the triggers, partly due to uncertainty in the interpretation of some regulatory texts, e.g., as to which ones are backward and which ones are forward looking.

We observe on a regular basis, for example, that the cumulative losses and default triggers are both put in place for the backward-looking triggers under (a) and (b).
As a general proposition, we believe the list of triggers proposed in this RTS should at least include and preferably be essentially similar to the trigger types from the SRT report.

Should it be felt absolutely necessary to add a further backward-looking trigger that is neither on cumulative losses nor cumulative defaults but is related to a credit enhancement threshold or percentage of losses on a tranche only, a grandfathering of the already closed STS transactions should be imperatively considered . In addition, PCS believes further triggers are needed to satisfy the needs for transactions which transfer the junior tranche risk.

PCS will elaborate in the main part of this response why it thinks that the proposed additional credit enhancement (or tranche thickness) related triggers should (1) not be the only further backward-looking triggers and (2) should not be calibrated by the regulator.

II. ANSWERS TO QUESTIONS FOR CONSULTATION

Q1: Do you agree with the specification made in Article 2?

PCS conceptually fully agrees with the intended specification but believes the wording could benefit from additional clarification.

It is market practice to refer the cumulative amounts of defaults and/or losses to the outstanding amount of the *initial portfolio at issuance or at the effective date, i.e. the date the credit protection starts* or to specify an absolute amount, an equivalent approach.

As a matter of drafting, PCS is concerned that the expression "*at the origination*" could be interpreted as a reference to the loan amounts at their individual origination dates, rather than, as we believe it to be meant, the initial outstanding amount as described above.

Also, PCS believes it would be helpful if the text could make clear that both a cumulative amount in percentage terms of the initial portfolio or, of course, also an absolute figure of a cumulative amount in the currency of the transaction would be acceptable. This would have the same effect but some investors may prefer such a wording since it can be directly related to the subordination levels.

Q2: Do you agree with the aim of Article 3 with regard to ensuring that the credit enhancement of the senior tranche does not fall below a certain threshold because of the non-sequential amortisation?

a) Discussion of the mechanics of the suggested triggers in article 3.

This trigger puts a floor to the enhancement of a senior tranche, which is normally the tranche held by the originator. We assume the way this trigger is supposed to work is that it defines a fixed amount (percentage of detachment point at "origination" which can be expressed as an amount in the currency of the notes) as a threshold. The current wording of article 3 needs to make it clear that it does not refer to a percentage decrease of the detachment point at origination but to the nominal amount of the detachment point at origination, decreased by pro-rata amortisation. "Issue date" or "effective date" may also be a better word than "origination" in removing any ambiguity as to the point in time at which the number is fixed.

Also, it needs to be made clear whether this threshold is net of deductions like losses (interim and final) or just the available credit enhancement whether it has already been used or not. This is key to the understanding of this trigger. If it ignores deductions by losses, it ends up being a static trigger, since it causes a switch to sequential amortisation as soon as a certain threshold has been reached. Including deductions for losses is much more effective in achieving the aims of the regulations whilst maintaining a sensible commercial balance.

Looking at the CRR Regulation, the calculation of the detachment point refers to the outstanding balance of the pool of underlying exposures, so we assume it takes into account any booked losses, but not defaults. It would be helpful if this was clarified in the RTS.

> CRR 2017/2401, article 256(2) For the purposes of Subsection 3, institutions shall set the detachment point (D) at the threshold at which losses within the pool of underlying exposures would result in a complete loss of principal for the tranche containing the relevant securitisation position.
>
> The detachment point (D) shall be expressed as a decimal value between zero and one and shall be equal to the greater of zero and the ratio of the outstanding balance of the pool of underlying exposures in the securitisation minus the outstanding balance of all tranches that rank senior to the tranche containing the relevant securitisation position to the outstanding balance of all the underlying exposures in the securitisation.

The "alternative option trigger" describes the increase of the sum of all interim and final protection payments as a percentage of the outstanding protected tranche (nominal at origination minus amortisation). This trigger is a dynamic trigger, since it describes a percentage of protection payments as a percentage of the outstanding protected tranche. For this trigger to be hit, part of the protected tranche must already have been decreased by losses to have a numerator which is divided by the outstanding tranche (disregarding decreases by losses).

This trigger is particularly sensitive to backloaded losses.

Although the two suggested triggers may be backward-looking triggers, PCS feels that there can be no "one size fits all" approach and the mechanics of the suggested triggers are only suitable for some types of transactions and certain protected tranches. Therefore, they can only add value in certain cases. In particular, the reason given in the RTS for putting the credit enhancement trigger in place, i.e. the concern that losses may only occur at the back end of the transaction, can be partly managed (1) by tightening up the language for credit event notification and (2) by making the cumulative default trigger obligatory since its time lag is six months shorter than the cumulative loss trigger.

b) How the triggers add value and what their limits are

Here is some of PCS's reasoning as to why these types of triggers should be included, their added value and limitations in comparison to the cumulative loss and default triggers:

- Regarding trigger 1, the credit enhancement threshold suggested by this trigger is in effect similar to the cumulative loss trigger, where an absolute amount of losses tips the transaction into sequential amortisation, but with a timing element. This trigger 1 would be hit, independently of the loss or default trigger, when the pro rata amortisation decreases the credit enhancement below a specified level. In effect it is just an absolute amount of threshold credit enhancement, which, if the amortisation schedule of a pool is known, can be predicted, assuming no or only small losses until that point in time and is designed to protect the investor from back-loaded losses. Given that the amortisation of a pool over time can be predicted it complements the cumulative loss and default triggers and its predictability can be implemented into all pricing models. One could go as far as saying that for a predictable pool amortisation this trigger is effectively a defined timing trigger for the pro rata amortisation to turn into sequential.

  This trigger, however, is only suitable for investors into a mezzanine tranche.

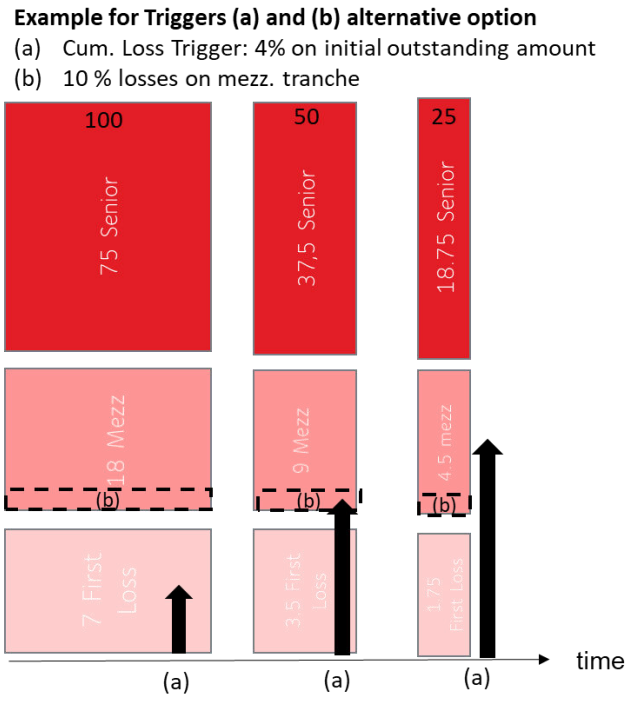
- The "alternative option" trigger is a dynamic trigger, the timing of which is not predictable because it is sensitive to losses that have occurred on the protected tranche divided by the initial nominal after subtracting amortisation amounts. This trigger is only hit when losses have already occurred on the relevant protected tranche.

- The "alternative option" trigger may be suitable for junior tranches since they are hit by expected losses in any case and are priced accordingly (see discussion on calibration below) but the calibration of this trigger would have to be very deal specific (tuned to expected losses) and potentially may not work.

- For (more junior regarding the attachment point) mezzanine investors it can be of some additional value, since it is more sensitive to the timing of losses than the cumulative default or loss triggers. In the case of forward-loaded losses or

well distributed losses the cumulative default trigger would be hit before the alternative option trigger, whereas in the case of back-loaded losses, the protected tranche can be already affected by substantive amounts of losses due to the pro rata amortisation, when the cumulative trigger has potentially yet to be hit.

- The "alternative option trigger" overtaking the cumulative default trigger for backloaded losses is illustrated below.



As seen in the illustration, a cumulative loss trigger of 4% of the initial the pool with a FLP of 7% (black arrows) gets hit very late if losses are back-loaded (here: after 75% of the pool has amortised 50% of the mezz. Tranche needs to be written down by losses, before the cumulative loss trigger (a) gest hit).

In this example the "alternative option trigger" becomes more sensitive than the cumulative default trigger after less than 50% of the portfolio has amortised.

- PCS believes that both triggers would add value. The first trigger is much easier for originators and investors to predict for a pool with an expected WAL/amortisation schedule so that it has an element of a timing trigger. The alternative option is a sensitive trigger which clearly complements the cumulative loss or default amount triggers and *may* work for junior tranches (although the percentages would need to be a lot higher), *does* work for junior mezzanine tranches but *does not* work for "more senior mezzanine tranches".
- The EBA argues that the trigger is supposed to "*ensure that the credit enhancement is still sufficient to cover the case where significant losses may occur at the end of the transaction, thus fulfilling the objective of the mandate*".

  Losses occurring at the end of the transaction should not be a particular risk under synthetic corporate loan STS transactions, as the initial losses need to be accounted for 6 months after the notification of a credit event and, thus, reduce the credit enhancement and will be caught by the trigger under (a). A back-loaded distribution of losses is only expected in securitisations where the

securitised assets react to an economic, sectoral or political shock which could occur towards the end of a transaction's term and, therefore, generate back-loaded losses or, but in the case of non-STS synthetics only, where the losses are only accounted for when the work-out had been finalised. Almost all SME and corporate synthetic securitisations include assets of very mixed origination dates and industries, most of them also have a revolving period, most of the loans are in one way or other refinancings in the context of a bank's relationship with the corporate. Therefore, protections against back-ended losses should only be envisaged for the very few transactions which do not display appropriate diversification of origination date or type rather than imposed on all STS deals.

PCS would also point out that additional risks of back-loaded losses can occur when credit events are not required in the documentation to be reported without delay. In such cases where notification is optional, PCS would agree that the credit enhancement trigger would be an important tool to address back-loaded losses resulting solely from the originator managing the timing of credit event notification.

In PCS's view delayed reporting of credit events could jeopardise the effectiveness of the cumulative default or loss trigger and the alternative option trigger. A clarification as to the rules on the timing of the notification of credit events deriving from the level 1 text would therefore be most welcome.

In summary, aside from the consequences of an option to report credit events later, for SME's and corporate loans there would not be additional risk of back-loaded losses in securitised pools that would be any different from losses occurring on corporate assets that are not securitised. In this respect, PCS notes that CRR and prudential regulators will allow capital requirements to decrease pro-rata on the nominal value of asset pools as it declines on the bank's books.

If credit events are reported in a timely manner though, PCS would also consider it to be effective to have a cumulative default trigger in addition to the cumulative loss trigger or alternatively an additional a timing or other backward looking trigger for the amortisation to switch to sequential. On the other hand, as long as the level 1 text is interpreted as allowing the notification of credit events to be an option and not an obligation, PCS sees a risk in back-loaded losses occurring.

Q3: Do you agree with the trigger set out in the Article or would you prefer the alternative option in order to meet the aim of this additional backward-looking trigger? Please justify your answer, providing, if possible, evidence of the outcome of both triggers based upon your past experience.

- As mentioned above, depending on the asset class, and whether there is a revolving period and a predictable amortisation schedule, the trigger adds a credit enhancement threshold, which can be a [EUR] amount of credit enhancement (and does not have to be expressed as a percentage), net of

losses already occurred and protects the originator holding the senior tranche from being hit.

- The alternative option is a dynamic trigger that is more sensitive to timing and prevents the subordination from amortising any further when the tranche is already hit. In PCS's view this trigger is more sensitive and needs to be closely coordinated with the cumulative default/loss trigger. The alternative option provides good protection to investors in a tranche which is likely to suffer losses from these becoming catastrophic. This leads to the calibration discussion. There are probably a lot of mezzanine tranches that are very unlikely to be hit by losses. There are some junior tranches for which the losses are expected and part of the pricing, and some tranches in between the two.

In summary, PCS would recommend permitting both types of triggers as further backward looking triggers and not making the choice dependent on the seniority of the protected tranche as this will allow the investor and originator to select the one that is most appropriate to the actual risk distribution.

Q4: Which level of the trigger would you consider more appropriate and why?

- It is mentioned under section 3.8 that the EBA *deems it appropriate to only calibrate the trigger under point (b)*. If for triggers (a) and (c) there is no calibration possible, we are somewhat at a loss as to why it is, in the view of EBA, necessary for the trigger (b) to be calibrated? In particular, the enhancement levels are not in any way standardised, depending on the approach (standardised or IRB) and the formula used or whether rating agencies are involved and there are great differences depending on the behaviour of the asset class, its granularity and the economics for the originator. In PCS's view a "calibration" of such a trigger is not possible for the reasons given above and therefore not recommended.

- Regarding the proposed trigger based on a threshold of credit enhancement, the EBA's aim of achieving standardisation by setting a percentage by which the credit enhancement may decrease can easily be circumvented by the originator/investor setting the level of the detachment point of the protected tranche accordingly. Enhancement levels until the senior detachment point can be freely set, as long as SRT is achieved. There are no fixed rules for setting the detachment point, the senior detachment point can reach into the "AAA" area, or only "BB" area, as the case may be, depending on (a) whether a junior (first loss) tranche has been sold as well etc.. Also, banks look at their own "economic capital" management and may decide to apply a higher or lower detachment point, depending on their own ability to absorb asset migration risk and therefore the risk weights increasing on the retained tranches.

- In short: there is no standard detachment point, from which a percentage of decrease could be sensibly calibrated. Also, if a percentage was imposed as part of the trigger, the originator could artificially increase the detachment point beyond what would be necessary to make an imposed trigger work. That would defeat the purpose of such a calibration.

- A similar analysis applies for the "alternative option trigger". A calibration of the percentage of losses compared to the tranche thickness is not possible, since the thickness of such a tranche can be very different, depending on the tranching selected by the parties. A mezz tranche can be very thin from the beginning, but unlikely to have a loss, a more junior mezz. tranche can be thicker; a junior tranche with no subordination is very different again, since it can detach at BB level, BBB or even AAA level. Although all transactions need to achieve SRT, a quantitative analysis of the tranchings would show a lot of differences, since it depends on (a) the mathematical distribution of expected and unexpected losses, (b) the lumpiness of a given portfolio and the way the SRT is achieved (through sale of mezz or Junior tranches or both) and (c) how much buffer the banks add to a detachment point (that reaches 10% risk weight) to take into account migration risk

For the reasons given above, PCS strongly disagrees with a calibration of such a trigger through the synthetic STS regulation since it (a) cannot be made to work in a standardized way and (b) if it was imposed, would be circumvented by the tranching.

The triggers are part of the SRT modelling which the relevant regulators need to approve. Given the differences between underlying pools, the right place for a calibration discussion of triggers would be the SRT approval process which is much more flexible and able to take into account idiosyncrasies.

Q5: Do you agree with the specification of the forward-looking trigger in Article 4? In your view, will the possibility of switching back to non-sequential, as set out in paragraph 6, be detrimental for the simplicity of the specific transaction and the objective of standardisation of STS on-balance-sheet securitisations?

- The forward-looking trigger for the switch from pro rata to sequential amortisation should also be seen in the context of the "stop replenishment trigger" which ends the revolving period described under (a) of paragraph 6 of the level 1 legislation. Any calculations made for this sequential trigger should follow the same rules as the "stop replenishment trigger", though the level at which the triggers are set will be different. The same applies to the "rise in losses trigger": if the "switch to sequential trigger" under (a) already includes the cumulative rise in losses in a transaction, they need to work in tandem. As to the suggested trigger mechanics themselves, PCS has no comments.

- Triggers that allow for a reversal from sequential to pro rata in case the trigger is cured are not detrimental to simplicity since, for other triggers like e.g. ending the revolving period, reversable triggers are often implemented. As long as the overall set of triggers includes performance related triggers which end the pro rata amortisation without being reversible, as is the case for the two backward-looking triggers under (a), it does not add complexity to allow the forward-looking trigger to be cured. On the contrary it seems a wise measure since forward-looking PD's can change when an IRB bank recalibrates internal

rating systems, or certain sectors therein, without the underlying assets migrating.

- The suggested waiting period of 4 consecutive quarters does not match the overall timing and speed of amortisation of these transactions. A waiting period of two quarters, (i.e. one further waiting period than the first quarter for the trigger to switch back) seems appropriate.

Q6: According to market practice, is it common that performance-related triggers can change several times the amortisation system of the tranches throughout the life of a synthetic securitisation? If so in your view, please provide concrete examples of triggers, distinguishing between backward-looking and forward-looking triggers?

- For the synthetic transactions we have seen so far, originators have defined the switch from pro rata to sequential amortisation as an event called "subordination event" or "sequential amortisation start date" or similar, all of which trigger a switch to sequential amortisation for the remainder of the transaction's life, regardless of whether the circumstances which caused that "event" are still subsisting. This does not mean, though, that in other transactions we have seen for the true sale STS verification, the inclusion of certain triggers which can be cured, is not market practice. Because of the much lower number of synthetic STS transactions seen by PCS so far, the fact that all triggers seen so far switched to sequential for the rest of the life may not be representative of market practice. Furthermore, as other asset classes enter the world of synthetics, this feature may become more relevant, since curable triggers are commonly seen in the true sale world in securitisations of shorter term assets like consumer assets or trade receivables.

- The key here is that at some stage the triggers need to become permanent, so a curable trigger can never be the ultimate trigger. The proposed trigger is not curable since it is a fixed threshold. The "alternative option trigger" is curable, if initial losses end up being less than expected. This seems a possibility since there could be an example of a large default hitting a thin tranche (and tipping the alternative option trigger) which could in the end turn out to have a high recovery rate.

- Summarising, on the topic of curability, PCS would recommend, that, if curable triggers are permitted, at least *one or two* of the three triggers should have a value, at which the amortisation would change permanently.

Q7: Do you agree that the information that the originator shall provide under Articles 7 and 26d of the Securitisation Regulation includes the information needed by the investor providing protection to understand and verify the functioning of the performance-related triggers in an STS on-balance-sheet securitisation?

- In PCS's view the article 7.1 reporting obligations for the quarterly report and significant event reporting are sufficient to capture the required reporting of triggers.
- However, we note that in our verification process we often find areas of disagreement with originators who believe a lower level of disclosure is required by article 7 than PCS believes is set out in the law. Accordingly, we believe the market would benefit from a more extensive set of guidelines, for example on trigger disclosures.

Q8: Since, as a first step before specifying the triggers above, the EBA reassessed the triggers included in recommendation 2 on Amortisation Structure of the EBA 2020 Report on significant risk transfer in securitisation (see Section 5.2), and some elements from them were taken on board in the draft RTS, stakeholders are also invited to comment on the suitability of other triggers included in that recommendation for the purpose of these draft RTS.

EBA REPORT ON SIGNIFICANT RISK TRANSFER IN SECURITISATION UNDER ARTICLES 244(6) AND 245(6) OF THE CAPITAL REQUIREMENTS REGULATION, EBA/Rep/2020/32, 3.3.2

Backward-looking triggers:

i. cumulative losses at a point in time higher than a given percentage of the lifetime expected losses (LTELs) at inception;

ii. cumulative non-matured defaults higher than a given percentage of the sum of the outstanding nominal amount of the tranche by which the risk is transferred and the tranches that are subordinated to it;

iii. increase in the cumulative amount of defaulted exposures/losses greater than a given percentage of the outstanding amount of the underlying portfolio;

iv. weighted average credit quality in the portfolio decreasing below a given prespecified level and/or the concentration of exposures in high credit risk (PD) buckets increasing above a pre-specified level.

Forward-looking triggers:

i. increase in the weighted average 1-year PD of the underlying portfolio (as determined in accordance with internal ratings based (IRB) requirements) greater than a given percentage;

ii. increase in the 1-year expected losses (ELs) of the underlying portfolio (as determined in accordance with IRB requirements) greater than a given percentage;

iii. increase in the cumulative amount of underlying exposures for which the credit risk has increased significantly since initial recognition (for example

international financial reporting standards (IFRS) 9 stage 2) greater than a given percentage of the outstanding amount of the underlying portfolio;

iv. granularity of the portfolio falling below a given pre-specified level.

- The triggers mentioned in the SRT should also be part of the STS criteria since the co-legislators elected to tie SRT and STS together. Clearly, the backward -looking trigger iii. needs to be aligned to this proposal (based on the outstanding amount at inception).

- Concentration of exposures in high risk (backward-looking in the SRT proposal) compared to the proposal for underlying exposures assigned to higher credit risk buckets as a forward-looking trigger seems contradictory. Amongst the forward-looking triggers the EL's instead of the PD's should be considered comparable to the current proposal and also permitted. Clarifications should be provided on this since the SRT triggers and STS triggers to not seem to go together, neither in substance nor in categorisation as forward- or backward-looking triggers.

- The triggers on granularity (forward looking) should be included, since they are part of the SRT trigger landscape. Granularity triggers make a lot of sense for more concentrated pools, such as pools of large corporate loans with a revolving period. Transactions with majority or even 100% large corporate loans are part of the synthetic transactions' universe.

- PCS believes the rules should permit originators for the purpose of 5(b) to apply all types of cumulative loss or default triggers (as long as they add additional value to the trigger chosen under (a)), including other variants of such triggers, e.g. measuring losses or defaults occurring within a certain rolling backward-looking time period. The calibration of these backward-looking triggers should be left to the SRT modelling of the originator and junior or mezz. investor, since no standardisation is possible for these types of triggers for the reasons given above, and, to the contrary, any fixed threshold could be circumvented by adjusting the tranching accordingly.

Q9: Do you have any other comments on these draft RTS?

The RTS should list all acceptable backward and forward-looking triggers aligning with the SRT triggers and not shy away from providing detailed explanations on how the triggers can be implemented. The list of additional backward-looking triggers ought to include triggers suitable for originators seeking to achieve SRT with (a) junior investors, (b) investors into several tranches, or parts of tranches, and (c) investors in large corporate asset transactions.

The RTS should include a grandfathering of current trigger languages and interpretations in existing STS deals.

III. SUMMARY

The risk of backloaded losses in diversified SME and corporate loan transactions is not meaningful unless an originator is allowed to delay notification of credit events. Accordingly, there would be value in clarifying that the law requires immediate credit event notification

The aim of avoiding the absolute credit enhancement threshold to decrease is key for protecting mezzanine tranche guarantors/investors and achieving SRT at the same time and should be added to the range of possible backward-looking triggers, although the triggers referring to credit enhancement or tranche thickness cannot be calibrated since there are multiple possibilities of circumvention due to the flexibility in the tranching of these private deals that do not involve rating agency type tranching.

In the end, cumulative loss or default triggers (here one could ask for both of them to become obligatory) can in some cases be more meaningful than credit enhancement triggers.

PCS would think it prudent and necessary

(1) to (continue to) accept both cumulative defaults and losses as backward-looking triggers for the purpose of complying with 5(a) and 5(b). This is in accordance with market practice for most current outstanding synthetic STS transactions. In addition, the other triggers mentioned in the SRT paper should be permitted and its usage clarified further in this context.

(2) not to define the trigger referring to credit enhancement levels or tranche thickness as the only further backward-looking trigger acceptable in all circumstances and for all asset classes and pool compositions for the reasons put together above.

(3) to clarify that enhancement triggers do not necessarily work for junior protected tranches.

(4) not to calibrate the trigger referring to credit enhancement levels or tranche thicknesses due to the complexity given by tranching and protection structures. Overall, calibration of such triggers is in PCS's view too complex to impose on originators through STS for the reasons given above. SRT approvals are the right context in which calibrations of triggers would need to be discussed. For synthetic transactions which are mainly private and often only have one or very few investors, the checks and balances for the triggers should come from the SRT test, the discussions originators have with investors and are tied to tranche thicknesses and pricing as well as the specifics of the underlying portfolios.

PCS agrees on the content and concept of the proposed article 2 but wishes to stress the importance of careful drafting.

The proposed backward-looking triggers in article 3 both work within their limitations (only applicable to mezz. investors). They cannot be the only permitted triggers though, for the reasons given above. An imposed calibration of such triggers is impossible for the reasons given above.

Article 4 on the forward-looking triggers, PCS takes the view that curability does not add complexity and is suitable for this trigger, as long as the two backward

looking triggers are not both curable as well.

Generally, PCS is asking for further clarifications to be made regarding other permitted triggers in alignment with the SRT proposal, to look into the credit event notification timing and reporting to be clarified and grandfathering of current synthetic STS transactions.

We hope this note will prove useful and are available to discuss any aspects on which you would wish further information.

Yours sincerely

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