Setting the standard
for securitisation

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

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

www.pcsmarket.org

European Commission
Rue de Spa
Brussels 1000
Belgium

21 February 2018

Response to the consultation on the LCR Rules

Prime Collateralised Securities (PCS) wishes to thank the Commission for consulting on possible changes to the Liquidity Coverage Ratio (LCR) rules. Although these proposals may appear at first blush to be merely technical adjustments, it would be, in our view, a grave mistake to underestimate their impact on the possibility of making the new STS regime a success and, therefore, on revitalising the European securitisation market – one of the key planks of the Capital Markets Union (CMU) project.

As a background to PCS' suggestions, we would like to touch on a number of key factors.

First, for the purposes of the LCR rules, one must bear in mind that securitisations meeting the STS standard (STS securitisations) are substantially more conservative than the securitisations currently allowed in level 2B (level 2B securitisations).

(a) the STS rules – which PCS has numbered at near one hundred separate criteria – are meaningfully more extensive that the rules binding the current level 2B securitisations. The STS rules contain provisions as to the expertise of originators and servicers, the adequacy of hedging, substantial "no-cherry picking" restriction, extensive documentary standards amongst many others that are not present in the current level 2B securitisation requirements. Accordingly, the STS securitisation category is substantially more conservative than the current level 2B category.

(b) the STS securitisations will also benefit from the new article 7 disclosure requirement of the STS Regulation. These only partially applied to level 2B securitisations when the Commission drafted the original LCR rules.

(c) the LCR rules quite correctly focus on the liquidity of the instruments to be found in a bank's buffer. Again, looking at market liquidity, one cannot compare

a level 2B securitisation whose criteria are to be checked individually by each investor and may be subject to disagreement with a public regulatory category such as STS. To be an STS securitisation, a transaction must be on an immediately checkable public register centrally held by ESMA. Its status is backed by an oversight regime with serious potential sanctions. It will, in many if not all cases, be verified by an independent and regulated third party certification agent. STS securitisations, like German Pfandbrief, are designed to become both a new market standard and an immediately identifiable asset class with a grounding in legislation. Neither is true of current level 2B securitisations. As such, the liquidity characteristics of STS securitisations will be superior to those of level 2B securitisations.

So STS securitisations are a "superior" asset class for the purposes of the LCR buffers when compared to the current level 2B assets.

Secondly, we respectfully suggest that the assertion that most current level 2B securitisations already meet the STS standard is very wrong. Based on PCS' own high-level analysis and a number of sample checks, we think that it is quite likely that ***ALMOST NO*** level 2B securitisations are STS compliant. This is not because of credit or structural deficiencies in those assets but because the STS criteria are so technical and so numerous that, without any *de minimis* latitude to deviate from the rules, it is unlikely that, at best, any but a handful of existing transactions fully meet the new STS requirement. It is also highly uncertain how many of the existing transactions (level 2B or others) can be "fixed" pursuant to the grandfathering rules set out in Article 43 of the STS Regulation.

Therefore, a simple replacement of the current level 2B securitisations by STS securitisations is likely to result in a very disorderly unwind of the securitisation component of banks' LCR buffer. This, together with the loss of LCR eligibility, would result in meaningful mark-to-market losses for all investors in those securitisations. This would include non-bank investors. Such losses inflicted on good faith purchasers appears iniquitous. This is especially true if no strong discernible regulatory or systemic benefit could be identified in the causing of such loss.

Thirdly, for numerous reasons which we (and many other market stakeholders) set out during the elaboration of the current LCR rules, the treatment of securitisation is excessively conservative and not consistent with the proper examination of the data. (Our arguments can be found in our original consultation response which can be found at:http://pcsmarket.org/wp-content/uploads/2014/04/PCS-response-to-EC-on-LCRs1.pdf).

Since that paper back in 2014, the data relating to securitisation but also to the liquidity behaviour of other asset classes (such as covered bonds and sovereigns) has, if anything, reinforced the argument that the current regime is over-conservative.

The Commission and co-legislators nevertheless chose, as is their prerogative, to set out a very conservative set of rules for securitisations in the LCR buffers. We do not seek to "re-litigate" these decisions. We mention them though to point out that the current starting point for the LCR rules, when dealing with securitisations, is already very conservative.

Having dealt with these preliminary but important matters, PCS would frame the basis of its proposals in the following way.

First, we do not believe that a conservative prudential requirement should be made more conservative merely because, in an unrelated legislative development, a new more conservative category of assets has been created absent any evidence that the current requirements are somehow deficient. This principle becomes even stronger when the proposed change would cause damage to good faith market participants.

Secondly, STS securitisations are a new category of instruments that did not exist at the time the original rules for the LCR were put in place. It is therefore both legitimate and sensible to modify the LCR rules to take into account this new regulatory development on which policy makers have worked for over three years and which is a central part of the CMU initiative.

Since, as we have seen, the STS securitisations benefit from superior liquidity characteristics to the existing level 2B assets, it is logical that any niche carved out for them in the LCR asset hierarchy should be at a higher level. We would strongly argue that the existing data on securitisation – especially when compared to covered bonds – already strongly supports this approach.

Finally, it is important to set these proposals within the strategic priorities of the European Union. The STS regime is part of the Capital Markets Union project. The purpose of this new securitisation regime is to stimulate the current small European market so that it can play a major role in financing European growth without creating systemic risks at bank level. It is designed to increase the European capital markets and diminish the continent's reliance on the banking system as well as open new channels of financing.

To do this though, it is vital that STS securitisations be a successful and desirable capital market instrument. Currently, obtaining STS status is a difficult, complex and, in some cases, costly endeavour. Yet, as of today, the only benefit of achieving this status is a reduced capital requirement for bank investors under the CRR Regulation. This is quite "thin pickings". It seems to PCS vital that the European authorities complete the edifice started with the STS Regulation if this key CMU project is to have a meaningful chance of success. This crucially means a strong place for STS securitisations in the LCR rules (consistent with the class' objective qualities) and within the Solvency II capital adequacy requirements. Without these further developments, PCS fears the STS securitisation asset class may not be able to fulfil the ambitious hopes that have been placed on it.

The PCS suggestion is therefore that:

(a) The existing level 2B securitisation definition be maintained and that assets meeting that definition remain eligible LCR assets on the same terms as to percentage and haircuts as set out in the current rules. Put colloquially, if they are good enough to be LCR eligible in today's conservative scheme, they should be good enough to be LCR eligible in tomorrow's updated regime. This will also prevent unwarranted and unnecessary economic damage to good faith purchasers.

(b) STS securitisations be made LCR eligible. But in recognition of their superior liquidity characteristics and their important role in delivering the European CMU aims, they are eligible for level 2A on the same terms as Level 2A covered bonds. Recognising the value of diversification and some probable concerns with over-reliance on securitisation in banks' liquidity buffers, we think it sensible to limit the maximum share and minimum haircut to those of CQS2 covered bonds – 40% and 15% - respectively

We note that the Commission is also proposing to retain as further requirements some non-STS criteria, namely a ratings limit, applicability to the senior tranche only and asset class restrictions.

(a) Since LCS eligibility turns on the liquidity of the underlying asset, we think a ratings requirement is sensible. The liquidity of lowly rated bonds is usually lower than that of similar more highly rated ones. However, as a consequences of the more or less wholesale downgrades of sovereign debt in Europe and the resulting impact of high quality securitisations, a requirement for eligible transactions to meet credit quality step 1 seems overly conservative. (We cannot ignore, for example, that some high-quality securitisations in less well rated countries currently trade higher than the sovereign).

In addition, by limiting eligibility to CQS1, the rules create a destabilising cliff effect. The downgrade of otherwise high-quality securitisations – especially for reasons unconnected to the bond, such as sovereign downgrades – can put pressure on banks' liquidity buffers. To allow this to occur at the fairly high CQS1 to CQS2 border seems to undermine the very stability of the banking system that the LCR rules are meant to buttress.

We would therefore recommend that the rules allow STS securitisations also to be within credit quality step 2. To compensate though, it would be right to increase the haircut to 35%.

(b) The seniority requirement remains sensible.

(c) Although many high-quality STS securitisations exist without the asset classes currently allowable for inclusion in the LCR, PCS acknowledges that some boundaries need to be in place to avoid esoteric, rare and hard-to-trade instruments becoming part of banks' liquidity buffers. The current regime is somewhat rough and ready but, on balance, works.

As an addendum to paragraph (a) on ratings, PCS has been informed that the credit quality step tables used by regulators to determine LCR eligibility depend on the bank whose buffers are being calculated. An advanced bank will be required to use the advance table whilst a standardised bank will be able to use the standardised table. This strikes us as highly illogical and with potentially perverse effects. The liquidity of an instrument – which is what the LCR rules focus on – is determined by the availability of willing buyers. In turn, that availability is determined, in part, by those buyers' views of the quality (including the credit quality) of the instruments up for sale. The advanced CQS table has very different and more severe correspondences to existing CRA ratings than the standardised table. The result is that a bank using the advanced approach is penalised because *the bank, as seller*, has a more sophisticated credit measuring system. But it is *the buyers'* view of credit that is relevant.

This approach means that there is no family of instruments that are LCR eligible since an instrument eligible for one type of bank may not be eligible for another. This is illogical and a drag on the success of a revitalisation of the European market and, particularly, on the potential success of the new STS regime. It would be a major improvement to the architecture of the LCR rules if this anomaly could be resolved.

Obviously, in PCS' suggestions for STS securitisations' eligibility extending to CQS2, we mean CQS2 in the standardised table, which goes down to the middle of the investment grade category for most CRAs.

Yours faithfully

Ian Bell
Head of the PCS Secretariat