Joint Position Paper — September 2018

Revisions to the Liquidity Coverage Ratio (LCR) risk damaging investor confidence in the new STS framework

Members of the above associations strongly support the new framework for simple, transparent and standardised securitisation ("STS") and have consistently argued that the LCR is a critical piece of regulation which, properly calibrated and with appropriate grandfathering provisions, can create the right conditions and incentives to support the recovery of the securitisation market in Europe.

Unfortunately, the treatment of both STS and non-STS securitisation under the revised Delegated Act on LCR published by the Commission on 13th July 2018 (the "STS LCR Proposals") falls significantly short of these objectives in a number of important respects:

- First and foremost, there is no "grandfathering" of existing transactions which are today LCR-compliant, and which have been purchased in good faith in reliance on the laws as they existed at the time. Absent any change in performance or liquidity of this asset class (we are not aware of any such change) it is disappointing to market participants that the law is changed retrospectively in this way.
- The amount of affected securities is material: we estimate that around €40 billion of securitisations are currently held by banks for LCR purposes. Removing their LCR-eligibility will cause the value of their holdings to fall.
- Bank investors have historically formed around one-third of investors[1] in securitisations: they provide liquidity and pricing support for other non-bank investors and the ability to be LCR-compliant is a primary reason for their investment.
- Because whatever is structured today will become non-compliant under the LCR in approximately 21 months' time, bank investors are now incentivised to reduce significantly their purchases in the primary market for a period until the STS regime is more firmly established, contributing to softening demand and pricing.
- Very few transactions which are currently LCR-eligible will qualify as STS. There will not be an automatic and obvious conversion of what is today LCR-eligible and what will in the future be STS. It is not possible to structure a STS securitisation today as the Level 2 work is not yet complete. We do not expect any STS transactions to be issued before at least mid to late Q2 2019 and thus the revised LCR will create market disruption.

[1] One-third is an average and the proportion could be higher depending on market circumstances and asset type.

- There is no promotion of STS securitisations to Level 2A: this both misses an opportunity and we believe does not meet the Commission's own stated policy from 2015: "The first step is to identify sound instruments based on clear eligibility criteria. The second step is to adjust the regulatory framework to allow a more risk-sensitive approach."[2]
- There is no adjusted standard for asset-backed commercial paper ("ABCP").
- Securitisations continue to be treated disproportionately harshly compared with covered bonds of a similar credit quality, especially with regard to the penal haircuts applicable to RMBS and autos (25%) and SMEs and consumer loans (35%) and the absence of any rating requirements at all under the LCR for some covered bonds.
- Continuing reliance on credit ratings is perpetuated, creating cliff-edge risks. As stated in our response to the Commission's consultation[3], we believe that while only senior tranches should be eligible, there should be no rating requirement for the inclusion of STS securitisations as Level 2A assets. However, if credit ratings are to be used then the STS LCR proposals seem to include a reference to credit quality step (CQS) 1 only in accordance with SEC-ERBA (Article 264 CRR); the previously present reference to Standardised Approach (SEC-SA under the amended CRR) has not been carried over. This not only creates a cliff-effect but also further limits LCR eligibility to "AAA" ratings only[4].

By taking such a harsh approach and providing such minimal support for the new STS framework, a very negative signal is sent to issuers and investors. This comes at a time when the supportive role of central banks such as the ECB and Bank of England is about to be gradually reduced, returning more securities to private investors. Liquidity volume will therefore progressively reduce. Such a future outlook surely requires policymakers to undertake stronger, more positive support for STS securitisation, rather than the creation of further disincentives. Market participants expected that, for financial stability reasons, the EU authorities would have taken this opportunity better to prepare for the impact of the expected reduction in the ECB and BoE funding programmes.

This unpredictability of regulatory treatment demonstrated by retrospectively removing existing LCR eligibility will have an insidious effect on bank investors. Bank treasurers must take long term decisions informed by the difficulties of operating in this sector. Anecdotally we are aware of a number of investors who have already decided to withdraw: we often hear "This asset class is 5% of my book and brings 95% of the regulatory problems". We fear that even after an establishment and bedding-in period for STS securitisation that this sector of demand will be permanently diminished.

The Commission should reconsider the STS LCR Proposals or an opportunity to boost STS will be missed and existing bank investors will be harmed

The STS LCR proposals are now subject to the three-month scrutiny period (ending in mid-October 2018) by the Council and the European Parliament.

The goal of developing the STS framework was for STS securitisation to be differentiated from transactions (primarily US sub-prime mortgages) that failed so badly during the crisis, and to be recognised as such by the applicable capital and liquidity regimes. Failure to do so has created a serious risk that the STS framework will simply not be attractive to issuers or investors, hindering progress on Capital Markets Union, increasing Europe's reliance on banks and denying funding to businesses and consumers.

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[2] European Commission Consultation Document on "An EU framework for simple, transparent and standardised securitisation" published on 18th February 2015, page 4.

[3] See further the Appendix, page 6.

[4] CQS 1 under the Standardised Approach allowed ratings from AAA to AA-.

However, even more worrying is the absence of the "grandfathering" provisions which will have a damaging effect on the LCR-eligible investments currently held by banks.

Therefore, we urge the Commission to reconsider their approach to the treatment of STS under the LCR Delegated Regulation and:

- primarily to "grandfather" all existing LCR-compliant securitisations until they mature;
- to carry over the reference to CQS 1 under both SEC-ERBA and SEC-SA;
- to promote all STS securitisations to Level 2A; and
- to allow an adjusted standard for certain other non-STS term securitisations and fully-supported ABCP transactions (per our response of 21st February).

We would be pleased to discuss any of these comments in further detail, or to provide any other assistance that would help facilitate your review and analysis.

Appendix - supporting arguments

Absence of "grandfathering" provisions is potentially very damaging

The STS LCR Proposals will come into effect in approximately 21 months after publication in the OJ, but with no "grandfathering". This is an issue AFME commented on in AFME's submission to the Commission (see "AFME Response to the LCR Revision, 21 February 2018).

We believe that there is a serious risk of disruption of markets and fire sales of affected securities. This is because very few if any existing transactions which currently qualify under the existing LCR criteria will qualify as STS because:

- there will not be an automatic, obvious or easy conversion of what is today LCR-compliant into what will from 1 January 2019 be STS. Existing transactions which today are LCR eligible will not have been designed to meet the new STS-based LCR regime, are unlikely to meet the many new STS criteria and cannot be easily amended to do so even if this is possible;
- it will not be practically achievable to issue new STS securitisations until several months into 2019 because of the uncertainty which remains during the ongoing Level 2 implementation process; and
- securitisation transactions typically have maturities well beyond 18 months, even with shorter maturity underlying assets such as auto loans.

The effect of this will be that:

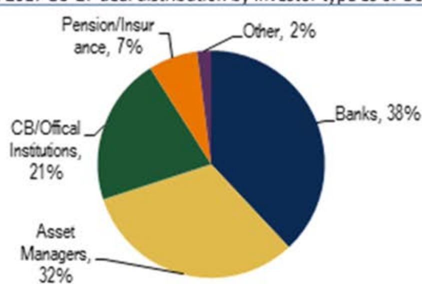
- existing LCR-eligible transactions will cease to be eligible causing prices to fall and damaging investors who have invested in good faith based upon the existing LCR rules;
- bank investors will be incentivised to suspend buying LCR-eligible transactions until well into 2019;
- even when STS securitisations become available, bank investors will be dissuaded from investing because of the harsh treatment suffered pre-STS; it becomes ever more difficult for bank treasuries to convince management that investment in securitisation is worth the trouble. Securitisations may form a small proportion of total LCR holdings, but retrospective and harsh treatment such as this creates stigma round the asset class in the eyes of bank management; and
- this comes on top of the already high complexity and operational burden of compliance, and the harsh regulatory capital treatment which will come into force on 1st January 2019 (especially when compared with covered bonds).

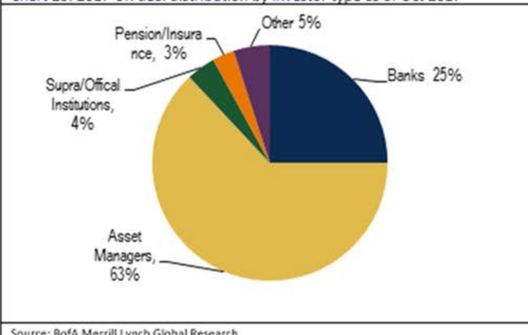
The amount of affected securities is material

We estimate that around €40 billion of securitisations are currently held by banks for LCR purposes and could be impacted by the STS LCR proposals. We have calculated this based on AFME data.

We started with AAA-rated RMBS and auto ABS tranches publicly issued in the EU and placed with investors (not retained). This equals around €200 billion in nominal terms. We then assumed a weighted average life for RMBS of 5 years and for auto ABS of 3 years, and when this is taken into account we are left with €120 billion outstanding.

It is next necessary to estimate what proportion of this €120 billion is held by bank treasuries for LCR purposes. The proportion of EU issuance that is bought by bank treasuries has been in decline: from around 50% several years ago to around 30% today. We take one-third as a reasonable and conservative estimate for the figure for today, which is broadly consistent with the charts for the EU27 and UK below, produced by Bank of America Merrill Lynch using public deal disclosure information. This is also consistent with information we have sourced from some of our other member firms. This results in a reasonable and conservative estimate of bank treasury holdings of securitisations for LCR purposes of around €40 billion.

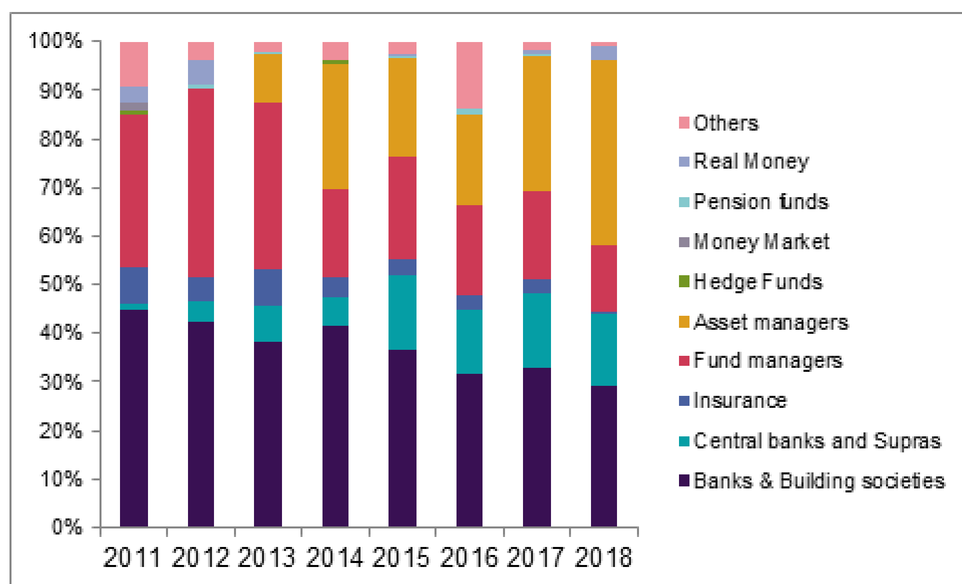




Bank participation in the European securitisation market has been falling

Data compiled by Concept ABS shows that bank participation has fallen on average from 45% in 2011 to 29% today. This highlights the challenges banks are facing as the regulatory burden of investing in securitisation has increased, including not least the much higher capital charges which will come into force on 1st January 2019.

Over the same period, central bank and supranational participation investment in the market has plugged the gap, increasing from an effective average participation rate of zero to 15% (bearing in mind that they invest mainly in traditional granular securitisations such as auto ABS, RMBS and SME ABS). This support is now set to reduce as the end of QE approaches. This makes it all the more important that incentives are created for banks to invest in STS securitisation (just as they have been for banks to invest in covered bonds). If banks continue to leave the market, the financing provided by securitisation to the real economy will also diminish. This makes it all the more important for STS securitisation to be promoted to Level 2A under the LCR.



Source: Concept ABS

Failure to promote STS securitisation to Level 2A misses a key opportunity

The intention of the STS criteria is "to restart high quality securitisation markets, without repeating the mistakes made before the 2008 financial crisis. The development of a simple, transparent and standardised securitisation market constitutes a building block of the Capital Markets Union ("CMU") and contributes to

the Commission's priority objective of supporting job creation and a return to sustainable growth" (Recital (2) of Regulation 2017/2402).

Reclassifying STS securitisations as Level 2A assets would have sent a strong signal regarding the prudential strength of the new securitisation framework. It would have created a strong incentive for bank investors to invest in the highest quality securitisations and would have redressed to some extent the continuing uneven playing field with covered bonds.

Many types of securitisations have demonstrated high levels of liquidity through and since the crisis. Academic research[5] has shown that securitisations and covered bonds did not exhibit radically different levels of liquidity, and that based on bid-ask spreads some securitisations were more liquid than covered bonds. Indeed, securitisations were more liquid than bank and sovereign bonds during the sovereign debt crisis of 2011-2012[6].

The credit and price performance of most European securitisations since 2014 have further confirmed their strong performance through and since the financial crisis.

There is no adjusted standard for ABCP

We argue for the inclusion and better treatment of fully-supported non-STS ABCP programmes at Level 2B. The STS ABCP criteria have been drawn so restrictively that very few if any existing ABCP programmes will actually qualify as STS, even if some of the underlying transactions within the programme may be STS. It is therefore sensible to propose an LCR approach that better reflects the characteristics of the European ABCP market.

Fully-supported ABCP programmes are 100% wrapped by a liquidity line provided by a bank, so that the investors in the ABCP have dual recourse not just to the securitised assets but also the bank provider of the liquidity line which is the first in line for repaying maturing ABCP is not refinanced. In this sense the credit risk is similar to that of a covered bond.

Fully supported ABCP funds the working capital needs of businesses and therefore supports real economy development and job creation achieving the Commission's priority objectives as stated above.

A short-term credit assessment of CQS 1 should apply.

Consistency is achieved with the MMF Regulation under which fully-supported ABCP programmes are included, alongside STS securitisations, as an eligible asset for money market funds. Therefore, the same holistic approach should be taken under the LCR treatment.

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[5] Covered Bond versus ABS liquidity: A comment of the EBA's proposed HQLA Definition. William Perraudin, Risk Control Limited. 24th January 2014.

[6] See "Appendix - supporting arguments".

Securitisations continue to be treated disproportionately harshly compared with covered bonds

LCR treatment of securitisations vs covered bonds (before STS)

	Level 1	Level 2A	Level 2B	Level 2B	
	Covered Bonds	Covered Bonds	Covered Bonds	Securitisation	Securitisation
	CQS 1	CQS 2	No rating requirement	CQS 1	CQS 1
				RMBS / autos / leases	SME / consumer
Maximum share	70%	40%	15%	15%	15%
Minimum haircut	7%	15%	30%	25%	35%

There should be no rating requirement for the inclusion of STS securitisations as Level 2A assets

We agree to a restriction to the most senior tranche for LCR eligibility.

However, the STS framework is deliberately not credit-rating dependent. This is both to reduce reliance on credit ratings in the EU regulatory system and to minimise the impact of sovereign rating caps. Varying ratings should be addressed in the quantum of haircuts applicable, not to the binary question of inclusion or not. This is the approach that has been taken with covered bonds. Making inclusion (at whatever level) dependent on credit ratings creates a cliff effect and results in the holder of the exposure being a forced seller should the rating change; especially if, as proposed, the rating requirement is now narrowed to AAA only.

Evidence shows that securitisations have a strong track record of liquidity, in many cases as good as covered bonds

AFME has consistently argued that many types of securitisations have demonstrated good levels of liquidity through and since the crisis. In January 2014, Professor William Perraudin of Risk Control Limited published Covered Bond versus ABS liquidity: A comment of the EBA's proposed HQLA Definition which showed that securitisations and covered bonds did not exhibit radically different levels of liquidity. Indeed, based on bid-ask spreads some securitisations have been more liquid than covered bonds.

In summary its conclusions were that when bid-ask spreads were examined:

- while on average covered bond bid-ask spreads were narrower than those of securitisations generally speaking, spreads for the more liquid securitisations were narrower than those of covered bonds, especially during the sovereign debt crisis of 2011-2012;
- some short maturity securitisations such as auto-loan backed securitisations demonstrated liquidity which was comparable to covered bonds and indeed markedly superior to non-Pfandbriefe covered bonds; and
- there was a danger in relying on a single dataset (as the EBA did in its conclusions regarding the treatment of securitisation under the LCR), and on methods which relied heavily on frequency of trading and turnover - rather than using trading cost measures such as spreads. For example, during the global financial crisis, when investors in auto ABS wished to dispose of their paper they were able to do so.

Securitisations were more liquid than bank and sovereign bonds during the sovereign debt crisis

Comparisons with covered bonds which are unfavourable to securitisation often omit that the market making mechanism for trading activity in covered bonds also collapsed in 2008 - but the covered bond market benefited from a public EUR 60 billion buying programme initiated by the ECB. Further, there are periods where data demonstrates that the price volatility of RMBS has been significantly lower than many other fixed income securities. See for example the spread volatility of residential mortgage-backed securities ("RMBS") compared with other fixed income securities during the sovereign debt crisis of 2011-2012 shown below.

Market Price Performance Jan 2011 – Jul 2013

European RMBS Price Performance vs. Other Instruments - Spread volatility by sector

	2011				2012				2013 to end July			
	CB	Bank	Sovs	RMBS	CB	Bank	Sovs	RMBS	CB	Bank	Sovs	RMBS
UK	0.9%	3.3%	1.1%	0.8%	1.0%	2.2%	1.6%	1.0%	0.4%	1.4%	0.7%	0.6%
France	1.5%	4.3%	3.1%	-	1.2%	2.7%	2.5%	-	0.5%	1.6%	0.8%	-
Germany	0.4%	0.8%	1.3%	-	0.5%	0.8%	1.2%	-	0.2%	0.6%	1.0%	-
Netherlands	0.7%	1.1%	1.9%	0.9%	1.0%	1.0%	1.8%	0.8%	0.8%	1.6%	0.8%	0.7%
Spain	2.3%	6.1%	8.8%	3.6%	3.3%	7.0%	9.5%	4.6%	3.4%	3.9%	5.2%	3.1%
Sweden	0.4%	2.6%	1.0%	-	0.5%	1.6%	1.4%	-	0.3%	1.0%	1.2%	-
Italy	3.0%	6.2%	9.1%	4.3%	2.7%	4.9%	7.5%	5.2%	2.0%	3.6%	5.1%	3.0%

Source: Bank of America Merrill Lynch Global Research

Lastly, as has been widely accepted, the credit and price performance of most European securitisations since 2014 to date have further confirmed their strong performance through and since the financial crisis.