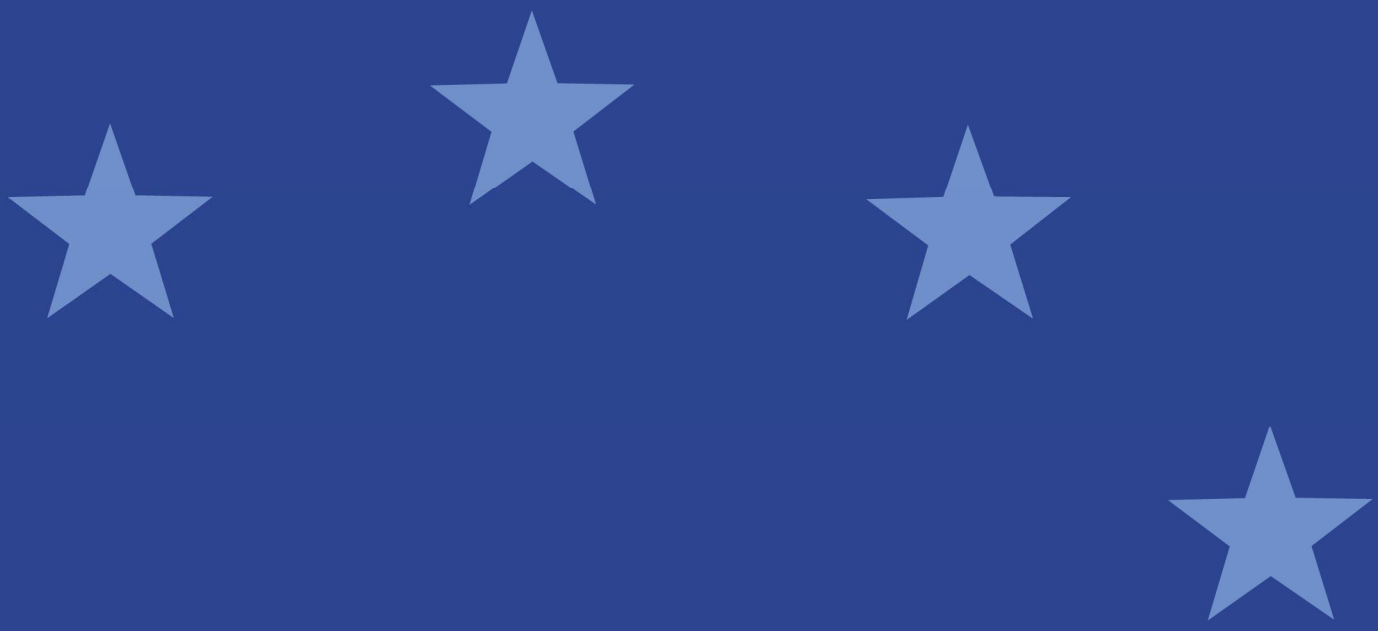
esma European Securities and Markets Authority

Response to public consultation

ESMA response to the European Commission consultation on "An EU framework for simple, transparent and standardised securitisation".



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An EU framework for simple, transparent and standardised securitisation: public consultation

Purpose of the consultation

In February 2015 the European Commission published a public consultation “An EU framework for simple, transparent and standardised securitisation”. This consultation represents a first step towards a possible initiative creating an EU framework for simple, transparent and standardised securitisation.

The consultative document aims to gather information and views from stakeholders on the current functioning of European securitisation markets and how the EU legal framework can be improved to create a sustainable market for high-quality securitisation.

The response from ESMA only addresses questions that fall within the area of expertise of ESMA and refers, where appropriate, to the report of the Joint Committee on securitisation regarding matters concerning transparency and disclosure information[1].

[1] Joint Committee report on securitisation (JC/2015/022) published on 12 May 2015, available at http://www.esma.europa.eu/system/files/jc_2015_022_-_final_jc_report_on_securitisation.pdf.

Introduction

1. ESMA appreciates the opportunity to respond to the questions raised by the Commission Consultation Document ("the Consultation Document") of 18 February 2015 that seeks comments on how to develop "simple, transparent and standardised securitisation".
2. In the present feedback document, in addition to overall comments, we provide responses to those questions that fall within the area of competence of ESMA and refer, where appropriate, to the report of the Joint Committee on securitisation regarding transparency and disclosure requirements.
3. ESMA's response seeks to present the view that provided investor's interests are appropriately safeguarded, securitisation could provide an alternative to bank funding. This would however require a credible regulatory framework to ensure investors can assess all the relevant factors before making an investment decision. In addition, any such initiative should be assessed on the basis of consistency with existing EU regulatory frameworks for disclosure, retention and due diligence.
4. Failures in the securitisation market played a role in causing the global financial crisis. This was partly due to a lack of incentive alignment between investors in securitised notes and originators of loans backing these notes (the so-called 'originate and distribute' model). While a number of new requirements have been put in place, caution needs to be maintained to ensure that the lessons from the past are properly reflected in any new framework aimed at reviving the securitisation market.

<u>Due diligence requirements must play a central role under the qualifying securitisation framework</u>

5. All securitisations, whatever their structural characteristics, should be analysed as complex products requiring sufficient data, expertise and modelling skills. Even 'simple and transparent' securitisations are considered to be too sophisticated investment instruments for the vast majority of investors operating at the retail level. Risk assessments of relevant products requires specific knowledge from investors, who need to be able to perform their own due diligence.
6. Provided that incentives are aligned in a comprehensive and consistent manner a framework for qualifying securitisations would help re-establish investors' confidence in SFIs. Under such a framework, investors could be provided with incentives to conduct adequate risk surveillance, monitor ongoing risks and perform thorough due diligence of their securitisation investments thereby demonstrating that they understand the risk profile of their securitisation as requested under CRR and Solvency II.
7. The introduction of labels to securitisation products (e.g. type-A securitisations) should not divert attention from the risks associated with such products. Hence, prospective investors must continue to determine whether or not a particular transaction meets the specific standards. Similarly, investors should not overly rely on external structured finance ratings in which ESMA has found shortcomings in CRAs' processes (for example with regards to the surveillance of structured finance credit ratings) which could affect the quality of the ratings. The SFI website to be set up by ESMA pursuant to Article 8b(4) of the CRA

Regulation[2] will contribute to enhancing investors' ability to comply with their due diligence obligations.

Ensuring consistency at EU level

8. In the wake of the financial crisis, the EU has built an extensive regulatory framework for securitisation including due diligence, disclosure and retention requirements for SFIs. A necessary step towards a European initiative is the development of a common set of basic concepts that can be used in the EU to achieve substantially equivalents goals.

9. Depending on the class of investors and the relevant regulatory framework to which they are subject (CRR, Solvency II, AIMFD, etc.), the Joint Committee report on securitisation identifies the inconsistencies regarding disclosure and due diligence requirements. The report also identifies where such inconsistencies lack justification and where they may give rise to unnecessary complexities and uncertainties that could impede the revival of the EU securitisation markets. Finally, any proposed regulatory initiatives should be developed and implemented in a manner that does not unduly conflict with other initiatives taken at global and European level.

Assessing the full effect of the ongoing reforms

10. The full potential, and implications, of the ongoing reforms mentioned above have not yet materialised. Furthermore, implementation work, such as the set-up of a website for SFI by ESMA and its expected launch on 1 January 2017, are still in their initial stages. In addition, work is underway to extend the disclosure requirements to assets not yet covered by the existing reporting templates such as private and bilateral transactions in SFIs and short term securitisations.

11. Through the below responses to the questions raised by the European Commission, ESMA aims to identify the challenges that fall within its expertise and refers, where appropriate, to the report of the Joint Committee on securitisation regarding matters concerning transparency and disclosure information on securitisation. The presentation of the issues follows the order set out in the EC CP.

IDENTIFICATION CRITERIA FOR SHORT TERM INSTRUMENTS

To what extent should criteria identifying simple, transparent, and standardised short-term securitisation instruments be developed? What criteria would be relevant (Q2 A)

12. In order to achieve a consistent EU transparency framework for securitisation, the transparency criteria for short term securitisation should be consistent with the disclosure

[2] Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies.

requirements already set out in the Regulatory Technical Standards on information on structured finance instruments[3] (hereafter CRA 3 RTS). CRA 3 RTS allows investors to have access to the data which is relevant to them to carry out the necessary due diligence on an ongoing basis.

13. CRA 3 RTS does not currently apply to asset-backed commercial programmes (ABCPs). However, a phase-in approach adopted under CRA 3 RTS allows for the possibility to extend the disclosure requirements to ABCPs. Hence, as soon as disclosure requirements in accordance with Article 8b of CRA 3 are applied to ABCP programmes, they will be subject to adequate transparency requirements.

14. Like for other SFIs, those requirements should ensure that all parties who hold a securitisation position in a securitisation transaction within an ABCP programme have access to all material information that is needed to perform a comprehensive and well-informed analysis of the risks arising in the securitisation.

15. However, the extension of the disclosure requirements to short term securitisation will need to consider their specific features so as to adapt them accordingly. These specific features include the heterogeneous and revolving nature of the underlying assets, the role of sponsors (through the use of liquidity lines and letters of credit), the assets purchased by the ABCP's vehicle (i.e. senior tranche) and the existence of confidentiality clauses to preserve the anonymity of parties involved in ABCP transactions.

COMPLIANCE WITH CRITERIA FOR QUALIFYING SECURITISATION

Compliance with criteria for qualifying securitisation (Q4)

16. The current patchwork of enforcement regimes is not in itself an efficient solution to a better functioning of the EU securitisation markets. As identified in the JC report on securitisation, there is a need for a consistent, comprehensive enforcement framework in the EU[4].

17. The enforcement element of any framework is essential to safeguarding investor's interests. Considering the wide range of stakeholders and regulators involved, the enforcement framework should not be considered in isolation from the existing regimes applying to securitisation[5], including Solvency II and Liquidity Coverage Ratio[6], which already contain criteria for identifying a "qualifying" securitisation.

[3] Commission Delegated Regulation (EU) 2015/3 published on 6 January 2015 at the Official Journal of European Union.
[4] In particular, such EU regime should consider the overall consistency of the sectorial regulations containing enforcement requirements including in Liquidity Coverage Ratio (2b assets) and Solvency II Delegated Act (Type 1 securitisation).
[5] See also IMF securitisation SDN observes that: "A binary two-tier, high/low-quality, classification system at the aggregate level risks creating a fragmented market. Significant "cliff effects" or discontinuities between similar product offerings might result where a slightly lower-quality loan pool attracts drastically lower investor interest if it barely fails to meet the qualifying "high-quality" requirement. Significant pricing and liquidity distortions between tiers may well be exploited by product originators where there is a strong incentive to only deals barely meet the minimum requirement in order to attract the "high-quality "designation."

18. With respect to enforcement of the disclosure and due diligence requirements, the current level 1 and level 2 regulations already contain requirements indicating which entity is responsible for reporting the information, the penalties and/or supervisory measures[7] and the competent authority that should be involved in the enforcement process. Ensuring a consistent enforcement framework across the existing regulations is one of the prerequisites for the efficient enforcement of EU criteria for qualifying instruments, thereby avoiding an additional layer of complexity for the enforcement of the EU criteria for qualifying SFIs.

ELEMENTS FOR A HARMONISED EU SECURITISATION STRUCTURE

What impact would further standardisation in the structuring process have on the development of EU securitisation markets? (Q5 A)

19. A certain degree of standardisation in securitisation transactions can be beneficial to issuers and investors alike. Examples of effective standardisation include the data files for loan-level data prescribed by the CRA 3 RTS.
20. "Standardisation" should not be seen as an "absolute" objective as standardisation across products as this could lead to a "one-size-fits-all approach" that does not sufficiently consider important structural differences between various SFIs.
21. In addition, while standardisation of the due diligence requirements for SFIs in the EU should be seen as desirable, the following are necessary steps prior to further action:
    - Assessment of the practices of the different categories of investors including the risks to which they may be exposed and the specific tranches in which they plan to invest;
    - Identification of the regulation against which due diligence requirements should be harmonised or standardised.
22. Moreover, the Joint Committee report on Securitisation recommends the following:
    - Where possible, harmonising the due diligence requirements (which in turn should guide the disclosure requirements in the EU);

[6] Under the Solvency II delegated act, a classification as type 1 securitisation – which refers to a category of securitisations which fulfils a number of requirements concerning the structure of the securitisation, the underlying exposures and disclosures (etc.) - are met. The same approach has been followed under the Liquidity Coverage Ratio (LCR) in which some securitisation instruments are eligible as level "2b" assets for credit institutions' liquidity buffers. To qualify for these purposes, ABS instruments will have to meet certain high quality requirements identical to those that will apply under the Solvency II delegated act.

[7] As an example, where an institution does not meet the requirements in Article 405, 406 or 409 of CRR in any material respect by reason of the negligence or omission of the institution, the competent authorities shall impose a proportionate additional risk weight of no less than 250% of the risk weight (capped at 1250%) which shall apply to the relevant securitisation positions in the manner specified in CRR Article 245(6) or Article 337(3) respectively.

- Investor reports should become a key operational tool reflecting the dynamics of SFIs;
- Data providers should also become responsible for reporting the information to a centralised public space;
- Admission to trading on an EU regulated market or offered to the public should be the key criteria to define which SFIs should be subject to the EU regulatory framework; and
- Loan by loan data should remain a key principle underpinning the due diligence requirements.

Would the publication by credit rating agencies of uncapped ratings (for securitisation instruments subject to sovereign ceilings) improve clarity for investors? (Q7B)

The use of sovereign ceilings in structured finance ratings

23. In the wake of the European sovereign debt crisis, some credit rating agencies (CRAs) have decided to include ceilings on securitisation ratings derived from the credit rating of the relevant sovereign. According to these CRAs, these credit rating ceilings are intended to reflect certain “tail risks” associated with a potential sovereign default that cannot be mitigated by additional credit enhancements. Therefore, in the opinion of some CRAs, structured finance ratings cannot be delinked from the creditworthiness of the relevant sovereign.

24. Some market participants have expressed concerns with regards to the calibration of these rating ceilings and have pointed to the reliance of structured finance ratings on sovereign ratings as a possible obstacle to the functioning of the securitisation market. Therefore it has been suggested that CRAs be required to publish "uncapped" ratings, as it arguably provides useful information to investors about the quality of the underlying assets and the credit enhancement applied. In their joint discussion paper on securitisation, the ECB and the Bank of England have suggested adding information in the form of a matrix showing implied ratings if the rating caps were to be set at higher levels.

CRA Regulation and regulatory treatment of credit ratings

25. The CRA Regulation contains a general clause (Article 23(1)) that prevents ESMA and any other public authority from interfering with the content of credit ratings or their methodologies.

26. However, the CRA regulation includes disclosure requirements which, amongst other things, requests CRAs, “when announcing a credit rating or a rating outlook, to explain in their press release or reports the key elements underlying the credit rating or the rating outlook”.

27. According to the Regulatory Technical Standard for the assessment of compliance of methodologies, CRAs are required to use credit methodologies that are “rigorous, systematic, continuous and subject to validation based on historical experience, including

back-testing". In particular, the CRA shall list and provide a detailed explanation of each qualitative and quantitative factor used and provide a statement of the importance of each qualitative or quantitative factor used within that methodology "including, where relevant, a description of and justification for related weightings assigned to those factors and their impact on credit ratings". On the basis of this requirement, the application of caps are typically already disclosed when they apply to a securitisation transaction.

28. Regarding the publication of credit ratings for which the applicable methodology has not been fully applied (i.e. sovereign cap), this might create confusion with regard to which credit ratings should be used for regulatory purposes.

Consistency across asset classes

29. Sovereign rating caps are not only building blocks of securitisation ratings but also of other asset classes such as bank ratings, covered bonds ratings or non-financial corporate ratings. Where the publication of the "uncapped rating" is requested, it should be applied consistently across asset classes where the distinction applies, as this might have the effect of re-qualifying some "measures" of creditworthiness (e.g. "financial strength ratings") as a "credit rating" as defined in the CRA regulation.

30. ESMA considers that the publication of the uncapped ratings should not become mandatory. Final credit ratings must reflect all the key elements including, where relevant, the ceiling factors underlying the credit rating or the rating outlook.

SECONDARY MARKETS, INFRASTRUCTURES AND ANCILLARY SERVICES

What else could be done to support the functioning of the secondary market? (Q8C)

31. When considering measures to support the functioning of the secondary market, two areas can be identified: i) the improvement of liquidity in the secondary market; and ii) the timely access to all documentation related to SFIs.

32. As regards the improvement of liquidity in the secondary markets for SFIs, the following aspects should be addressed:

    - the broad range of SFIs (from "plain vanilla" SFIs to bespoke SFIs);
    - the particular structure of the securitisation market which is decentralised, led by institutional investors and dealers who play a key role by providing quoted prices.

33. Structured finance products are within the scope of the MiFID II trading transparency requirements for which ESMA is currently developing implementing measures. In principle, MIFID II provides sufficient policy instruments to properly calibrate these trading transparency requirements. Finally, it should be noted that any structural changes in the structured finance market may ultimately also have an impact on how to calibrate those measures in the future.

34. Regarding the second area, investors should be able to conduct appropriate due diligence and ongoing monitoring of their investments' performance. Timely loan-level or granular

pool stratification data on the risk characteristics of the underlying pool and standardised investor reports should be readily available to current and potential investors at least quarterly throughout the life of the securitisation. Therefore, the frequency of the due diligence and disclosure requirements should be well articulated.

35. It is also necessary to ensure that the nature of these requirements is not duplicative: originators, issuers or sponsors (or, more generally "data providers" as suggested in the JC report on securitisation) can provide the relevant data on one occasion and in one format in order to avoid large increases in marginal costs for making data available with little or no incremental benefit to investors[8].

[8] Cf. Recommendation 4 of the JC report: on securitisation: "*As long as the "data owner" (issuer/sponsor/originator) holds responsibility for the quality of the information, there should be flexibility for the market to determine the most efficient entity to provide the relevant information for disclosure purposes. For example, the "data provider" is allowed to submit the information under the Eurosystem loan-level data initiative*".