21 February 2018

European Commission
Rue de Spa
Brussels

Dear Sir or Madam

Draft Delegated Act amending the Commission Delegated Regulation (EU) 2015/61 (the "LCR Delegated Regulation") on the Liquidity Coverage Ratio ("LCR")

AFME comments on securitisation and wider prudential aspects

AFME supports in principle the integration into the LCR Delegated Regulation of the new simple, transparent and standardised ("STS") criteria for securitisation. It is sensible to update and make consistent the existing LCR criteria with the new European securitisation framework.

AFME has consistently supported the Commission's proposals for a new framework for both STS and non-STS securitisations. We are confident that the long-term impact of the new regime can be positive. However, this will only be the case if critical related EU legislation such as the LCR Delegated Regulation is calibrated to create the right conditions and incentives to support the recovery of safe and well-regulated securitisation in Europe as a key pillar of Capital Markets Union.

Unfortunately the amendments proposed by the Commission to the LCR Delegated Regulation do not achieve this. This letter sets out our alternative proposal together with supporting arguments and evidence.

Our proposal

We propose firstly that all STS securitisations, whether term or ABCP, should be classified as Level 2A assets with maximum allocations and minimum haircuts equivalent to the current treatment of covered bonds of CQS 2. There should be no rating requirement, but only the senior tranche should be eligible.

We propose secondly that non-STS securitisations:

- which are term securitisations and comply with the requirements of Article 13, or
- which are ABCP and are fully-supported (as defined in Regulation 2017/2402), are not re-securitisations and do not include any underlying exposures which are securitisations or synthetic securitisations

Association for Financial Markets in Europe
London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700
Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971
Frankfurt Office: Skyper Villa, Taunusanlage 1, 60329 Frankfurt am Main, Germany T: +49 (0)69 5050 60590
www.afme.eu

Company Registration No: 6996678 Registered Office: 39th Floor, 25 Canada Square, London E14 5LQ
AFME is registered on the EU Transparency Register, registration number 65110063986-76

should continue to be treated as Level 2B assets with the same maximum allocations and minimum haircuts as apply today save that non-STS ABCP programmes which are fully-supported should receive a minimum haircut of 15%.

AFME proposals for new treatment of securitisations vs covered bonds (after STS)

	Level 1	Level 2A	Level 2B	Level 2A	Level 2B
	Covered Bonds	Covered Bonds	Covered Bonds	STS securitisations	Non-STS securitisations
Rating requirement if any	CQS 1	CQS 2	No rating requirement	Senior only[1], but no rating requirement	Senior only. CQS 1 for standard banks and CQS 2 for IRB banks. See below.
Scope of application				All STS, term and ABCP	Non-STS which complies with Article 13 (for term) or conditions set out above (for ABCP)
Maximum share	70%	40%	15%	40%	15%
Minimum haircut	7%	15%	30%	15%	15% for fully supported ABCP; 25% / 35% as per Art. 13(14) otherwise

While they should be senior, 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.

[1] Not necessarily AAA/Aaa.

The rating requirement for non-STS securitisations requires adjustment to restore a level playing field

The existing LCR rule for banks on the Standard Approach is CQS 1 which is AA and above. The equivalent rule for banks on the Internal Ratings Based Approach is AAA only. See the mapping rules for different kinds of banks published by CEBS (now EBA).

We do not understand why the rating requirement is tighter for more sophisticated banks. Further, a restriction to AAA creates difficulties in the context of sovereign rating caps. Our proposal therefore seeks to restore a level playing field across banks and across member states.

An alternative approach would be to prescribe the highest achievable rating in the applicable member state.

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. In this sense the credit risk is similar to that of a covered bond.

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.

Policy arguments

The Commission's policy objective should be to restart high quality securitisation markets

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 will be a crucial opportunity to send a strong signal regarding the prudential strength of the new securitisation framework. It will create a strong incentive for bank investors to invest in the highest quality securitisations, and will redress to some extent the continuing very uneven playing field with covered bonds.

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. Professor William Perraudin of Risk Control Limited published a study in 2014 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.

We submit a further copy of Professor Perraudin's report with this response.

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: BofA Merrill Lynch Global Research

Lastly, 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.

The Commission should level the LCR playing field between securitisations and covered bonds

While the Commission took note to some extent of the analysis described above and included not just RMBS[2] but also other types of securitisations in the LCR Delegated Regulation, the treatment of securitisations under the LCR Delegated Regulation remains extremely harsh.

2 This was the recommendation of the EBA, which we did not agree with.

Existing 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%

Comments on proposed revisions to the detailed criteria of the current LCR Delegated Regulation

Article 13(2)(a)

Article 13(2)(a) should be deleted for STS securitisations. The STS approach is not rating-specific.

Article 13(2)(b)

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

While this is somewhat at odds with the STS approach (which is not tranche-specific), we believe this is justified for the purpose of defining high-quality liquid assets in the context of the LCR, and that there are solid arguments that senior, highly-rated tranches are more liquid.

Articles 13(2)(g), 37 and 13(14)

The current Article 13(2)(g) should not apply to STS securitisations because it is both largely repetitive of the STS criterion requiring homogeneity and also explicitly restricts the asset classes that are available. This is inconsistent with the STS approach, which is not based on asset classes.

We also respectfully remind the Commission that Regulation 2017/2402 is intended to set a common standard for identifying qualifying securitisations in general. The explanatory memorandum published in conjunction with the original legislative proposals refers to this and suggests that only material liquidity-specific matters should be imposed on top of the STS criteria in the context of the revised LCR provisions.

The current Article 13(2)(g) should continue to apply to non-STS securitisations, as should Article 37.

Any adjustment of Article 13(2)(g) would also require a consequential amendment to Article 13(14).

Article 31(6)

Point 6 of Article 31 of the LCR Delegated Regulation provides for banks, when determining assumed 30-day cash outflows in the LCR, to apply a 10% conversion factor (CF) to the unfunded portions of certain liquidity facilities that banks provide to securitisation special purpose entities (SSPEs). This is an exception to the 100% CF that generally applies to credit and liquidity facilities to SSPEs under point 8 of Article 31. The exception uses a look-through approach under which a commitment to an SSPE, which in turn supports a facility provided to a bank's corporate customer, gets the CF that would apply to a commitment provided directly to the customer. Otherwise, Point 8 of Article 31 requires that banks apply a 100% CF to undrawn committed amounts that can be drawn down within 30 days under other liquidity facilities provided to SSPEs, under " arrangements under which the institution is required to buy or swap assets from an SSPE", and under credit and liquidity facilities to financial customers (which include SSPEs) not covered in points 1 through 7 of that Article.

While we welcome the provision of a look-through approach as set out in point 6 of Article 31, the existing wording raises a number of issues that we believe should be corrected and clarified by amendments to the LCR Delegated Regulation. Among other things, it applies the look-through only to liquidity facilities to non-financial customers and not to financial customers. Even before the adoption of the CRR, we advocated that the look-through principle should be applied more broadly to facilities provided to both non-financial customers and financial customers [(see AFME letters to the Commission dated 11 Feb. 2013, 12 May 2014 and 6 Jun. 2014)]. While the existing wording applies to liquidity commitments, the look-through approach should also apply to credit commitments that a bank provides to its customers using an SSPE structure without any capital markets financing. The existing provisions also require application of 100% CF to "arrangements under which the institution is required to buy or swap assets from an SSPE", which is confusing as such "arrangements" may include liquidity commitments that would get the more favourable 10% CF. The proposed amending regulation would amend point 6 of Article 31 to correct the placement of one comma, which would add some clarity, but would not otherwise change these provisions.

The US bank regulatory agencies, in their final rule implementing the LCR in the United States (available at https://fdic.gov/news/board/2014/2014-09-03_notice_dis_b_fr.pdf, the "US LCR Rule"), have applied the look-through approach

in a clearer and more consistent way. Where a special purpose entity (SPE) is a consolidated subsidiary of another company (defined as a company that is consolidated with that other company under US generally accepted accounting principles), the rule applies the same CF to a credit or liquidity commitment to the SPE as it would apply to a credit or liquidity commitment to the other company, whether that company is a financial customer or a non-financial customer (see US LCR Rule s__32(e)(iii)-(ix). While we would not expect the Commission to adopt an approach based on accounting consolidation, in the interest of creating and maintaining a more level playing field between banks subject to US and EU regulation, the Commission should amend the LCR Delegated Regulation to apply the look-through approach, as in the US LCR Rule, according to the type of entity selling assets to the SSPE.

We recommend that the Commission amend point 6 of Article 31 to apply the look-through approach consistently to both credit facilities and liquidity facilities and to both financial and non-financial customers and to clarify the reference to contractual limit on drawing. We also recommend that the Commission remove the wording (in paragraph 8(b) of Article 31) that requires 100% CF "for "arrangements under which the institution is required to buy or swap assets from an SSPE", as the treatment of commitments to SSPEs supporting facilities provided to customers as described in point 6 of Article 31 should not depend on whether a commitment takes the form of a loan, purchase, swap or some other form. Accordingly, we propose that the Commission adopt amendments to points 6 and 8 of Article 31 as shown in Annex 1 to this letter.

Transitional arrangements

The proposed amendments to the LCR Delegated Regulation are silent as to transitional or grandfathering provisions. Sensible treatment of existing transactions, entered into in good faith on the basis of the existing LCR criteria, is crucial. Otherwise there is a serious risk of disruption of markets and fire sales of affected securities.

This is because very few transactions which currently qualify under the existing LCR criteria will qualify as STS. There will not be an automatic and obvious conversion of what is today LCR-compliant and what will from 1st January 2019 be STS.

For example, one requirement to qualify as STS is the obligation to meet new disclosure requirements under Article 7 of Regulation 2017/2402: originators are unlikely to have collected relevant information in this regard prior to ESMA finalising its templates (which is work in progress). Existing transactions, which are of high quality and qualify in other respects, will have been structured before such a requirement comes into effect and simply will not be able to comply.

The proposed amendments should be supplemented to make clear that:

- All securitisations which currently meet the existing LCR criteria should be able to retain their existing treatment until their maturity, regardless of whether they also qualify as STS or not; and
- If they subsequently qualify as STS they should be reclassified as Level 2A as per above.

Wider prudential considerations arising from the proposed revisions to the LCR Delegated Regulation (not related to securitisation)

One of the main changes has been to correct a drafting error in the LCR Delegated Act which inadvertently linked outflow rates for repos with operational requirements for liquid assets. The drafting error had been known about quite widely and its correction expected. We understand, however, that there will be an implementation period of 18 months for this and other corrections such as referencing mistakes. In the meantime, it would be useful for a formal statement that firms should apply the correct and intended approaches to mitigate the risk of inconsistent treatments being taken by different regulators.

In the meantime, we would like to raise observations in the following specific areas:

Connected Clients

We note that there has also been a change to the definition of a retail deposit under Article 3 whereby deposits held by SMEs or companies which are eligible would now need to be 'aggregated on a group of connected clients basis'.

AFME has in previous work on connected clients with the EBA noted that we do not consider that it is appropriate for the concept of connected clients developed based on a credit risk framework to be applied to directly for liquidity risk management. This is particularly the case, for instance, when counterparties whose financial health may be linked owing to an economic relationship, may not exhibit the same propensity to withdraw deposits or other short-term investments in funding. In addition, the proposal would overlay some of the existing behavioural considerations in the regulation including, for example, Article 25 which defines a EUR 500k balance across accounts as an indicator of when to require higher outflow rates. Accordingly, we believe that the consideration of liquidity risk arising from 'connected clients' would need its own framework.

In the meantime, there would be very considerable operational challenges for firms in seeking to identify connected clients for liquidity purposes as this has not been undertaken previously and information may not currently be available for many counterparties.

Treatment of non-financial customers

We have noted the changes to Articles 31A(2) and 32(3)(a) and would note that it is not clear how the changes in relation to non-financial customers interacts with Article 23(1)(f). In particular, Article 31A appears to relate to the renewal or extension of existing loans but this outflow should already be covered in Article 23(1)(f) 'planned outflows related to renewal or extension of new retail or wholesale loans'.

In addition, part of Article 32(3)(a) covering the reduction of inflows from non-financial customers has been removed and instead the excess of commitments to extend funding exceeding inflows are now subject to an outflow rate. This would mean in practice that under the new approach inflows would not be reduced but would be subject to the inflow cap while a new outflow is added. This will result in increased liquid asset requirements and raise the costs associated with lending to non-financial customers.

Third Country Central Banks

Article 28 of the existing Delegated Act provides that liabilities resulting from secured lending and capital market driven transactions maturing within 30 days receive a 0% outflow rate if the lender is central bank. This encompasses all central banks, including third country central banks, whereas the new proposal is restricting the application of the 0% outflow rate to 'domestic central banks' only and the rationale for this is not clear.

We would note also continuing operational considerations for institutions in seeking to avoid the potential for the double-counting of inflows and HQLA in relation to third country central banks.

Additional areas for clarification

The proposed amendments to the inflow and outflow calculation mechanics for collateral swaps (Article 28(4) and Article 32(3)(e)) provide that an inflow is recognised "if the asset lent is subject to a lower haircut under Chapter 2 [of the LCR Delegated Regulation] than the asset borrowed" (and vice versa for outflows). Chapter 2 of the LCR Delegated Regulation provides haircuts only in respect of HLQA. Taken literally, the amendments therefore appear to recognise only collateral swaps relating to different types of HQLA (as opposed to collateral swaps including a non-HQLA limb) as creating inflows and outflows. Presumably this is not the intention, and non-HQLA should be deemed subject to a 100% haircut for this purpose.

Separately, Article 30(5) now mentions explicitly shorts covered by unsecured borrowers while the existing standard implied both unsecured and secured borrowers and it is not clear whether a change to the rule is intended.

We hope the contents of this response are helpful and as ever remain at your disposal to discuss our proposals and comments in further detail, should you wish.

Yours faithfully

[redacted]

[redacted]

Annex 1

From LCR Delegated Regulation Art. 31

6. The undrawn committed amount of **a credit facility or** a liquidity facility that has been provided to an SSPE for the purpose of enabling such an SSPE to purchase assets, other than securities**,** from **a** client~~s that are not financial customers,~~ **of the credit institution** shall be multiplied by 10 % **(in the case of a credit facility where the client is not a financial customer), 30% (in the case of a liquidity facility where the client is not a financial customer) or 40% (in the case of a credit facility where the client is a financial customer)** to the extent that ~~it~~ **the committed amount of the facility** exceeds the **maximum** amount ~~of assets~~ **that** currently ~~purchased from~~ **the** ~~client~~ **can be drawn** and where **that** maximum amount ~~that can be drawn~~ is contractually limited **based on** ~~to~~ the amount of **eligible** assets currently purchased.

8. The credit institution shall multiply the maximum amount that can be drawn down from other undrawn committed credit **facilities** and undrawn committed liquidity facilities within 30 calendar days by the corresponding outflow rate as follows:

(a) 40 % for credit and liquidity facilities extended to credit institutions and for credit facilities extended to other regulated financial institutions, including insurance undertakings and investment firms, CIUs or non-open ended investment scheme;

(b) 100% for liquidity facilities that the institution has granted to SSPEs other than those referred to in paragraph 6 ~~**and for arrangements under which the institution is required to buy or swap assets from an SSPE**~~;

(c) 100 % for credit and liquidity facilities to financial customers not referred to in points (a) and (b) and paragraphs 1 to 7.