CHENAVARI INVESTMENT MANAGERS

Response to the Consultative Document:

"Criteria for Identifying Simple, Transparent and Comparable Securitisations"

Chenavari welcomes the opportunity to comment on the joint Basel Committee on Banking Supervision (BCBS) / Board of the International Organization of Securities Commissions (IOSCO) consultative document setting out the idea of “simple, transparent and comparable (STC) securitisations” and the associated draft determination criteria.

Chenavari is an active investor in both primary and secondary securitisation markets in Europe, and manages in excess of €1.5bn of ABS and structured finance investments across the majority of underlying asset classes. Deep investment analysis and due diligence is our bread and butter, and we have completed this process across many hundreds of opportunities. Thus we trust our insights will be of value to the committee.

Broadly speaking, Chenavari supports any initiatives put in place which will support and sustain the future of a functioning and healthy securitisation market. The concept of simple, transparent and comparable securitisation, although different in detail, has similarities with the Prime Collateral Securitisations initiative launched some years ago, and with the backing of BCBS and IOSCO should gain further traction in maintaining the quality and comparability of securitisations issued.

However, we strongly highlight the need to avoid creating a two-tier market for securitisations, particularly since the criteria would seem to be binary in application – that is, for a particular securitisation, it is either judged to qualify by meeting all the criteria, or to not qualify. If the aim is to create lower risk weightings for qualifying securitisations (as is alluded to in BCBS 303[1]), then this could unduly constrain important areas of securitisation issuance which can bring new sources of finance into the real economy. Examples of assets classes broadly not qualifying the draft criteria are Collateralised Loan Obligations (CLO) and Commercial Mortgage Backed Securitisations (CMBS).

Chenavari would also question the subjectivity of many areas of the criteria, and how the criteria will be applied to a securitisation. Such subjectivity dictates that the careful judgement of an independent party might be employed, yet it is not suggested who might play this role and at what cost. It is likely that investors will ultimately bear the costs of the provision of any professional opinion, and therefore the conditions should not be overly onerous. Unless either (i) a single independent body is used for subjectivity judgements or (ii) subjectivity is completely removed from the criteria, then it will be very difficult to achieve consistency of application across the various structures and asset classes, which will result in a loss of industry credibility for the initiative.

Chenavari also highlights that the securitisation market has never been designed as anything other than a market for professional and experienced investors. Experienced investors are mandated on their capabilities to understand such products, and should have the resources and relevant expertise available to undertake due diligence on complex transaction structures, underlying asset pools, documentation and third parties service providers independent of such a framework. In the same way, experienced investors appreciate the flexibility and opportunity created by non-standardisation in the market, and whilst supporting the transparency element of the proposals, we find the simple and comparable elements to be necessary. We also believe it is important regulators promote regulations that recognise the importance securitisation has as an investment format enabling the transfer of credit risks between sophisticated market participants. In this sense, when securitisation structures suffer losses, however severe, the structures are in fact working, particularly when the transfer of risk benefits the state guaranteed bank depositors. It is also in this sense counter-intuitive to penalise either on a regulatory basis or indirectly via regulatory bias on liquidity particular classes of credit.

[1] “Revisions to the Securitisation Framework” – Basel Committee on Banking Supervision, 11 December 2014

We also believe that it is possible to have simple, standardised and comparable securitisations where such a label applies to certain senior tranches, but not to the more junior tranches, for instances with the senior classes being able to sold to retail investors, with junior classes being confined to institutional investors and specialised investor market who are able to evaluate more complex risk levels, dealing with for instance maturity transformation risk, or other criterion mentioned in this paper.

The remainder of this letter details Chenavari's responses to the four questions posed by the committee, and then gives more detailed comments and thoughts on the individual criteria.

1. *Do respondents agree that the criteria achieve the goals they aim to achieve? In particular, do respondents believe that the criteria could help investors to identify "simple", "transparent" and "comparable" securitisations?*

As noted above, the majority of the criteria are not objective enough to be consistently applied globally, and therefore we struggle to see how this can enhance comparability. A lot of the criteria point towards third party providers having a sufficient and strong track record, and a potentially unintended consequence of this would be to concentrate providers so that only the longest established can or will in practice be selected for certain transactions. In the context of market diversity, and market and regulatory concerns around GSIFI dominance this would be unfortunate.

Investors are generally mandated by their funders as a consequence of their expertise in navigating the securitisation markets, and therefore we would dispute the need for simplicity and comparability, which removes this diversification advantage. Investors should always be extremely thorough and careful in their assessment of risks of a product, and therefore we can only support the transparency element of these proposals – as long as sufficiently detailed information is set out in a clear and unambiguous format, then we think this is a sufficient goal.

2. *Do respondents agree with the STC criteria set out in the annex of this paper? In particular, are they clear enough to allow for the development by the financial sector of simple, transparent and comparable securitisations? Or do respondents think they are too detailed as globally applicable criteria? The annex provides guidance on each criterion. Which additional criteria would respondents consider necessary, if any, and what additional provisions would be useful or necessary to support the use of the criteria? What are respondents' views on the "additional considerations" set out under some criteria in the annex? Should they become part of the criteria? Are there particular criteria that could hinder the development of sustainable securitisation markets due, for example, to the costliness of their implementation?*

As has already been mentioned in the response above, the establishment of objective criteria will be key to the success of this initiative. A non-exhaustive list of examples of excessive subjectivity in the criteria would be:

- Asset Performance History: "…originator, sponsor, servicer and other parties with a fiduciary responsibility to the securitisation have an established performance history for substantially similar claims" – who determines what is an established history, and does this block new market entrants
- Payment Status: "…aware of evidence indicating a material increase in expected losses or of enforcement actions" – question whether this would exclude entire Eurozone jurisdictions under stress
- Fiduciary and Contractual Responsibilities: "…such parties should be able to demonstrate expertise in the servicing of the underlying credit claims or receivables, supported by a

management team with extensive industry experience" – again, how is this to be judged and against what benchmark?

Furthermore, the catch-all nature of the criteria unfairly disadvantages many asset classes – for example, CLO cannot qualify (despite their actively managed nature – within tight constraints – leading to the lowest default rate amongst asset classes in Europe). Also CMBS structures are de facto excluded (due to the refinancing requirement).

3. *What are respondents' views on the state of short-term securitisation markets and the need for initiatives with involvement from public authorities? Do respondents consider useful the development of differentiating criteria for ABCP, in a manner similar to that of term securitisations? The BCBS and IOSCO would particularly welcome any data and descriptions illustrating the state of short-term securitisation markets by jurisdiction and the views of respondents on concrete comparable criteria that could be applied to short-term securitisations.*

Chenavari does not participate in the short-term securitisation markets; therefore we are not placed to express a view.

4. *What are respondents' views on the level of standardisation of securitisation transactions' documentation? Would some minimum level of standardisation of prospectuses, investor reports and key transaction terms be beneficial? Do respondents think there are other areas that could benefit from more standardisation? Would a standardised template including where to find the relevant information in the prospectus be helpful? The BCBS and IOSCO would particularly welcome a description, by jurisdiction, of the extent to which different elements of initial documentation are standardised.*

It is Chenavari's view that there already exists a large degree of standardisation of documentation within each asset class. Standardisation has also been helped by the Prospectus Directive which sets out the minimum standards of information requirement. Also, one must be careful not to standardise to the point of reducing 'usability' of the document – what is key for one transaction/asset class will not be key for another. Chenavari feels that it is not burdensome for sophisticated investors to locate the relevant information, due to the degree of standardisation of terms and layout which already exist.

<u>Annex: Detailed Responses to Criteria</u>

1: Nature of Assets

- homogeneous assets
  - Jurisdiction and legal system are not appropriate in many cases, for instance - UK mortgages, where investor market has long accepted UK RMBS can include credits and security under English and Welsh, Scottish and Northern Irish law.
  - We believe that such a limitation would also likely be inappropriate in other European areas – (for instance, Benelux countries) where legal systems are similar, and indeed have also converged in respect of European legislation (i.e. in relation to consumer credit)

- With regard to "No reference of complex or complicated formulae or exotic derivatives"- noting Footnote 5- "The Global Association of Risk Professionals (GARP) defines an exotic instrument as a financial asset or liability with features making it more complex than simpler, plain vanilla products." it would appear that the referenced definition of "complex" or "exotic", might end up being, not simple or vanilla. We feel the investor and issuing markets are already sufficiently aware of what they consider vanilla interest rates for bonds on a market by market basis, and do not think it would be helpful for any work to be undertaken to propose an overriding definition on thesemarket's behalf.
- With regard to standardised defined terms as to rental, principal, interest, or principal and interest payments, we do not believe these are helpful. Investors in securitisation prior to, and post crisis were able to review the prospectus to determine which cash flow elements constituted these terms, and compare them across peer groups and previous transactions.
- Equally, we believe it is important that global regulatory rules do not end up entrenching for instance, swap providers in the transaction (for instance balance guaranteed swap providers who investors will typically require have a given standard of credit worthiness - swapping various underlying mortgage rate products resetting at different timings, or fixed rates, into for instance a standardised interest index plus margin), reducing competition within the structures. We also see these rules as potentially damaging for structures which incorporate features that are less reliant on swap providers (for instance, inverse rate floating notes, caps and floors have been available in various jurisdictions for sale to sophisticated institutional investors to successfully manage interest rate risk within securitisation structures)
- In this light, we believe that it is possible to have simple, standardised and comparable securitisations where such a label applies to certain senior tranches, but not to the more junior tranches, for instances with the senior classes being able to sold to retail investors, with junior classes being confined to institutional investors and specialised investor market who are able to evaluate more complex risk levels.
- Additional Consideration- we do not believe that it is helpful to further define these terms on behalf of sophisticated, market knowledgeable investors. We would suggest that "Homogeneity with respect to geographical origin" might be modified to "Homogeneity with respect to various underlying political or regional origins governing the credits"

2. Asset Performance History

- We support the intention of this criterion, but do not believe that there is significantly more to be done than for investors to be provided with loan-by-loan or other similarly granular data for the relevant portfolio of assets backing the securitised instrument and for the originators to confirm accuracy to the purchasers.
- It may potentially be unhelpful to maintain the wording in relation to the disclosure of "New and potentially more exotic classes" - as we believe a number of these items should be standardly disclosed across all securitised instruments.
- With respect to the statement "verifiable loss performance data" - it is unclear what standard "verifiable" might entrench in the investor community. We do not believe it is helpful to add in new service providers to perform verification activities.
- Additional Considerations - We note footnote 6, but we believe a preferable approach, which does not in practice (due to investor conservatism) lead to either anti-competitive effects within the legislation, or to the closure of the market to new but efficient service providers and market participants especially for first time issuers, is for the additional consideration "*investors should consider whether the originator, sponsor, servicer and other parties with a fiduciary responsibility to the securitisation have an established performance history for substantially similar credit claims or receivables to those*

being securitised and for an appropriately long period of time." to either be withdrawn or modified to apply only to unregulated entities, as while we appreciate that neither of the criterion, or our suggested modification would have prevented either Lehman Brother or Northern Rock securitisations, we believe these criteria are better dealt with via separate regulatory licencing regimes, and/or by pricing differential charged by investors for first time issuers.

- An additional anti-competitive effect of the additional consideration criterion may also be to restrict new geographical entrants into servicing the European market, which we believe is not the intent.

3. Payment Status

- We are concerned about the impact of the statement "*parties to the securitisation are aware of evidence indicating a material increase in expected losses or of enforcement actions*" - which is expressed extremely widely- it is unclear who the parties to the securitisation should be (beyond the short list of examples at footnote 8), and it is unclear by what mechanism, or by what right they would communicate this (for instance confidentiality issues which might apply). It is unclear what their liability might be should they be wrong in their assessment, especially so, where they are a party to a securitisation (for instance a "*party with a fiduciary responsibility*", which might include a European institutional trustee - but who does not have any asset specific expertise able to make this judgment).
- We are also concerned about how this statement might apply where there are underlying contractual variations that are undertaken within the prudent servicing standard, which is the standard sophisticated investors expect to be applied to the underlying pool of credits.

4. Consistency of Underwriting

- It is unclear what uniform origination standards would mean, or how they should be assessed by investors. In the context of consumer credits, it may raise anti-competition issues
- We do not believe that the phrase "*non-deteriorating credit standards*" is helpful - credit standards by their nature are adjusted by the risk/reward appetite of investors both in the relevant originating entity, and of the investors in the securitised bonds.
- What is important is the comparability of how an issuer may be changing their standards from one issue to another. It would be helpful to ensure that changes in underwriting criteria, for instance between series issuance from the same platform, are highlighted to investors in the prospectus

5. Asset Selection and Transfer

- In relation to the statement " *the performance of the securitisation should not rely upon the initial and ongoing selection of assets through active management on a discretionary basis of the securitisation's underlying portfolio*." we do not believe there is a material difference between a discretionary selected pool and the use of a counterparty to the securitisation with a track-record, suggested as a requirement under section 2.
- Given the breadth of the current regulatory definitions of securitisation, we also believe there needs to be a regulatory reconsideration as to whether non-granular pools or pools with active discretionary management should have a differing approach. We also believe that a distinction needs to be made between the mechanism of risk transfer (securitisation) and the risks transferred. It is important both for regulators and market participants that the securitisation market enables true risk transfer, recognising the importance that securitisation can play in diversification of the holders of financial risk inherent in asset classes.

- It is also our view that it should in principle be possible to achieve a transfer of risk via non-true sale mechanisms, and that these should be able to be discussed with national regulators in the context of national laws.

6. Initial and Ongoing Data

- We agree in principle and believe it should be clear that data sufficient to meet investor CRR and AIFMD requirements be provided within the European jurisdictions.
- We do not believe that "*the initial portfolio should be reviewed for conformity with the eligibility requirements by an appropriate independent third party, other than a credit rating agency, such as an independent accounting practice or the calculation agent or management company for the transaction*." is in practice a cost-effective investor protection. If implemented, it should be an alternative open to investors to accept that eligibility criteria are checked against defaulted assets.

7. Redemption of Cashflows

- The criteria in relation to reliance on the sale/refinancing of the credit claim or receivable we do not believe is helpful. In particular, we believe may be unhelpful in facilitating financial risk transfer for real economy assets, such as buildings, which are financed on a non-granular basis. We believe it is important that any criteria for simple, standardised and comparable securitisations focus on the comparability of the mechanism of the transfer (the securitisation structure) , and the comparability of the asset class whose risk is being transferred, without in practice restricting the asset classes which are able to access the market via securitisations. It is important to note here the difference in sophistication of analysis between institutional and less sophisticated investors in assessing the asset class.

8. Currency and Interest rate assets and liability mismatches

- We do not believe it is necessarily helpful to require industry standard master agreements.
- It is not clear what is intended by the criterion "*only derivative used for genuine hedging purposes should be allowed*" , and we are concerned about the extent to which this can be verified by investors (for instance - would an accounting opinion be required?). It is important to avoid entrenching the use of 3rd party service providers with limited remits, where these risks can be and are already are evaluated by investors themselves.

9. Payment Priority and Observability

- We believe that overall this proposed criteria maybe overly restrictive
- We agree with general approach set out in paragraph 1.
- We do not believe that the proposed restrictions set out in paragraph 2 are necessarily appropriate in all cases, for instance, it may be appropriate for a particular junior note to be issued to protect against a clearly specified risk, which is then repaid in priority to a senior note when the risk is no longer present.
- We agree with the approach set out in paragraph 3.
- The penultimate paragraph appears to be overly prescriptive in approach.

10. Voting and enforcement rights

- We generally find this to already be the case in the market, however, in the case of CMBS, it should be clear that the junior noteholders rights of consultation and to appoint work-out advisors (special servicing rights) do not constitute voting rights, within the context of this criterion.

11. Documentation Disclosure and Legal Review

- We agree with this criterion. It would be helpful in publicly listed deals, if the market authorities, who hold the prospectuses, also held the relevant deal documentation on the listing authority website (for an additional portion of listing fee).
- We believe it is important that investors are able to review and access all transaction legal opinions relating to the risks in the transactions as often there are important assumptions and qualifications which are relevant to the investment decision.
- We also believe it is important that for public deals, documentation is available to institutional investors on a non-password protected basis
- Overall we agree and would find it helpful for investors to be able to review the material contracts at the same time as the prospectus is being marketed, but recognised that this is not always possible. In the EU, the prospectus rules, which require material disclosure of the terms of the transaction, we believe, cover this risk.

12. Alignment of Interest

- We do not believe that the Additional Consideration is helpful within the EU region, as there are already sufficient legal safeguards in place ensuring that risk retention takes place.

13. Fiduciary and Contractual Responsibility

- We generally agree with the philosophy of these critera, but would note our comments above regarding competition issues and restricting market access relating to the statement "*To help ensure servicers have extensive workout expertise, thorough legal and collateral knowledge and a proven track record in loss mitigation, such parties should be able to demonstrate expertise in the servicing of the underlying credit claims or receivables, supported by a management team with extensive industry experience.*"
- In relation to the additional criterion, we would note our point relating to junior CMBS special servicing rights above, which should be differentiated by such voting provisions.
- In relation to "*To increase the likelihood that those identified as having a fiduciary responsibility towards investors as well as the servicer execute their duties in full on a timely basis, remuneration should be such that these parties are incentivised and able to meet their responsibilities in full and on a timely basis.*", we believe that this is already the case, due to the fact that, for instance trustees are able to seek an indemnity from noteholders (which ends up being economically equivalent), when there is an action required by investors (for instance, upon a default).
- It is also important to note that in some jurisdictions, a fiduciary relationship may not exist at all points during the life a transaction, for instance, US indenture trustees is considered to only have fiduciary duties <u>post</u> default.

14. Transparency to Investors

- We broadly agree with the criteria set out in paragraph 1.
- We do not believe that the criteria set out in paragraph 2 are in practice helpful as a global rule, as in practice these items will vary by asset class and jurisdiction. It may be helpful to reconsider this approach, by requiring that the form of investor report be set out in the prospectus, so that investors can review this, and if there are uncertainties raise this during the marketing phases, to resolve these.