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Basel Committee on Banking Supervision
www.bis.org/bcbs/commentupload.htm

BCBS CONSULTATIVE DOCUMENT: CAPITAL TREATMENT FOR "SIMPLE, STANDARD AND COMPARABLE" SECURITISATIONS

Moody's Investors Service ("MIS") appreciates the opportunity to provide comments to the Basel Committee on Banking Supervision ("BCBS") on the consultative document: *Capital treatment for "simple, standard and comparable" securitisations* (the "Paper").

In the letter we have set out our general comments on the introduction of a specific capital framework for simple, transparent and comparable ("STC") securitisations. In Annex I, we have provided our comments to the questions posed in the consultative document.

MIS has provided its views on the STC criteria in responding to previous policymaker consultations on STC securitisation as well as on the "simple, standard and transparent" ("STS") framework in the European Union.[1]In addition, we have indicated that we understand the benefit an STC classification may have as justification for policy makers to implement an STC capital framework, particularly in regard to the predictability, certainty and level of assessment of the risk. As suggested by the consultation paper of the BCBS and the International Organization of Securities Commission ("IOSCO"), the STC principles are only the foundation on which additional criteria can be added, such as credit risk.

[1] For example, see MIS' responses to the European Commission's consultation paper on an *EU framework for "simple, standard and transparent" securitisation* : https://www.moodys.com/research/Moodys-Investors-Service-Comments-on-the-European-Commission-Consultation-Paper--PBC_182306 and the BCBS-IOSCO consultation paper*: Criteria for identifying "simple, transparent and comparable" securitisations*: https://www.moodys.com/research/Moodys-Investors-Service-Response-to-BCBS-IOSCO-Consultative-Document-Criteria--PBC_180494.

MIS supports the development of STC as a means of re-igniting the securitisation market. Highly rated European asset-backed securities ("ABS") and residential mortgage-backed securities ("RMBS") have performed well, particularly given the significant economic stresses in Europe. However, some market observers still doubt the creditworthiness of securitisations and believe it is not possible to fully assess their risks. The definition of what constitutes STC will help reduce this lingering stigma by introducing commonly understood standards for transactions features. The resulting expansion of a stronger securitisation market will enable a broader distribution of credit risk among financial institutions and third-party investors, and help expand the pool of funding to support the global economy's financing needs.

However, STC should not be relied on as an exclusive stamp of credit quality. STS can help market participants understand the risks associated with securitisation and underlying asset performance, but will not remove them. Investors should maintain standards of due diligence as part of their own internal investment guidelines, policies and procedures. To the extent that qualifying securitisations are intended to satisfy criteria for STC, the balance should be in favor of investors receiving the optimal amount and quality of information to make informed decisions.

Subject to our comments on the additional criteria, the STC criteria will help mitigate the current regulatory capital impediments to functioning securitisation markets, as well as continuing to help eliminate the stigma attached to such markets.

We trust that you will find our comments helpful and would be pleased to discuss our views with you at your convenience.

Yours sincerely

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Managing Director EMEA Structured Finance

Annex 1

Q1. Do respondents agree with the rationale for introducing STC criteria into the capital framework? Are there any other aspects that the Committee should consider before introducing STC criteria into the capital framework that are not already reflected in the rationale above?

Yes, please see our cover letter above.

Q2. Do respondents agree that, for the purpose of alternative capital treatment, additional criteria are required? What are respondents' views regarding the additional criteria presented in Annex 1?

We have commented on a select number of additional criteria as set out in the paper:

A1: Nature of assets

Regarding the additional criteria on homogeneous pools, we disagree with the assertion that a pool including a combination of auto loans and auto leases is non-homogeneous. Auto leases may include different types of products with varying risk profiles; some auto leases are very similar to auto loans in terms of their characteristics and risks. In this regard, we would not always consider these combined pools to be non-homogeneous.

In addition, the new criteria that determines whether auto loans are "homogenous" states that they should have:

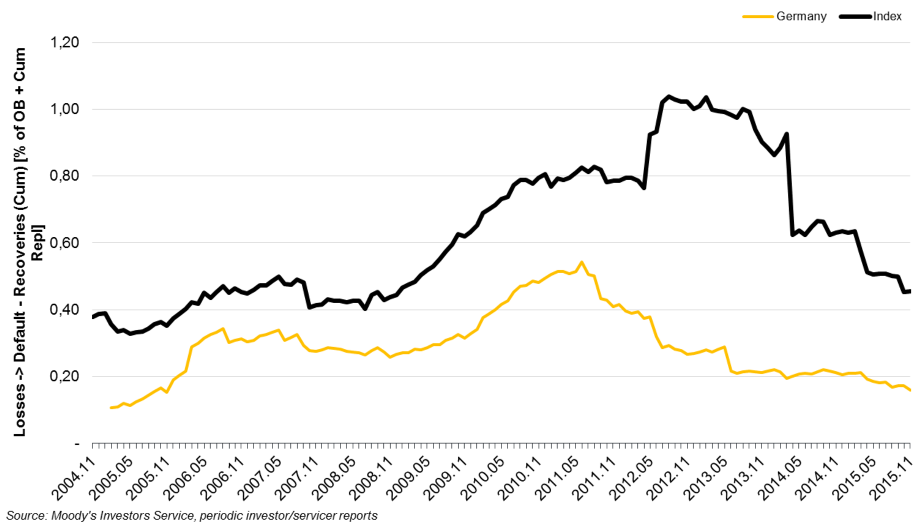
> *"level monthly payments that fully amortise the amount financed over its original term, except that the payment in the first or last month during the life of the loan may be minimally different from the level payment."*

We assume this comment is primarily aimed at lease deals with residual value exposure[2], however it rules out a much wider body of transactions with strong performance history. For example, this criteria would exclude deals with balloon loan pools where the balloon component is a material proportion of the loan. This would exclude much of the German auto loan market, where the majority of the pools have balloon loans and the balloon component is typically at least 40% of the initial financed amount.

[2] For a detailed comparison on auto lease asset-backed securities (ABS) transactions with low residual value (RV) and the criteria for simple, transparent and standard (STS) securitisations, see our Sector Comment "Standard, Transparent, Simple Criteria are Consistent with Our View of RV Risk in Relation to Auto ABS", 4 February 2016. https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_1011270

An exclusion is not justifiable given the strong historical performance, clearly evident in the following data. The overall performance of EMEA Auto loan and lease ABS has been strong over the last decade, with default and loss index levels well below 2% and 1% respectively. German auto transactions significantly outperform the market in terms of pool performance, both with regard to defaults and ultimate losses (see Exhibit 1 and 2)[3].

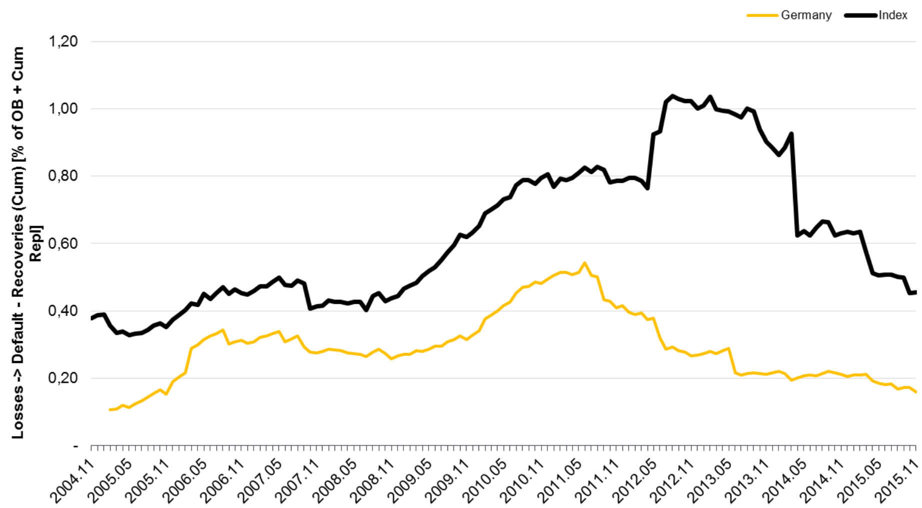
Exhibit 1: Auto ABS (loans & leases) – Defaults Germany vs. EMEA Index



Source: Moody's Investors Services

[3] The low level of pool losses indicates that an investor's risk of experiencing losses at the tranche level is quite limited. Across all 9,688 EMEA ABS and residential mortgage-backed securities (RMBS) tranches we have rated since 1993, only 29 subordinated notes (or less than 0.3%) suffered principal losses to date. Among these 29 tranches, only one stems from a transaction securitising a mixed portfolio of Spanish auto and consumer loans. See our Special Comment "Senior European ABS and RMBS tranches will remain insulated from principal losses," 8 June 2015; https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_1005572.

Exhibit 2: Auto ABS (loans & leases) – Losses Germany vs. EMEA Index



Source: Moody's Investors Service, periodic investor/servicer reports

<u>A2: Asset performance history</u>

The original requirements to show an "established asset performance history" are flexible enough to cater to various asset classes. However, the new additional criteria referring to "one complete economic cycle" may complicate the ability to meet this criteria, as:

(a) it is less flexible than referring to "established performance history," yet it remains ambiguous, with a potential for wide and varying definitions of an "economic cycle";

(b) it could potentially exclude consumer ABS, for example, as a typical product term for auto ABS is 60 months; which could be interpreted as being less than "one complete economic cycle";

(c) the five- and seven-year asset performance data periods included as additional criteria for retail and non-retail, respectively, may not be flexible enough to cater for all asset classes (e.g., auto transactions should be able to illustrate five years of data).

<u>B8: Currency and interest-rate asset and liability mismatches</u>

Considering the transactions rated by MIS that are not fully hedged, and that present either a basis interest-rate risk or a fixed-to-floating rate risk, the majority do not post a separate fully-funded reserve to mitigate this risk. Rather, credit enhancement is often mutualised. Therefore, when we analyse the transaction's structure, we consider the overall credit enhancement available to cover several types of risks - including the risk of being, or becoming, unhedged.

In addition, there is no mention of the quality of the swap counterparty. Using a "weak" counterparty could create an additional layer of uncertainty in the structure and may not fully mitigate the foreign exchange and currency risks.

D16: Granularity of the pool

The requirement that "a single obligor should not exceed 1% of the aggregated outstanding exposure value" is consistent with diversified RMBS. However, there is no differentiation between new and seasoned RMBS transactions for STC; importantly, seasoned de-leveraged deals show much higher concentration over time. Thus, a granular deal may increase in concentration as it ages. We address the risk of concentration for de-leveraging deals in our methodology[4] that considers this small pool dynamic. Our analysis would consider the case of an amortising transaction leading to an increase in the exposure to a certain obligor over time. Performing assets usually repay earlier, which would potentially increase concentration related to the worst performer(s) in the pool. Our methodologies typically take into account any obligor concentration without specifying a maximum individual concentration.

Criteria D17: Relationship between the originator and the servicer of the securitised assets

In our rating analysis, we address the strength of the third party servicer through our methodology for operational risks.[5] The BCBS suggests that operational risk is reduced by combining the originator and servicer. In our view, a third-party servicer mitigates risk, especially in the case where a deal is experiencing stress due to an originator's default. A key consideration is whether an entity can service the assets when the servicer defaults, as opposed to its ability to do so when the servicer is solvent. We expect poor asset performance is more likely when the originator defaults, so a combined originator and servicer increases the likelihood that the servicer will be unable to perform its duties at the time when it is most needed. Conversely, a third-party servicer facilitates the continuity of noteholder payments even when the originator is in default, thereby helping to mitigate the link with the seller of the assets, which is the core function of true-sale securitisation.

In terms of transparency and data reporting, if a separate servicer is looking after the assets, we consider that the kind of modifications and restructurings seen in markets such as Italy and Spain, which can serve to reduce the transparency of the delinquent and default numbers, would

[4] As per our methodology, "during the life of the transaction, as pool sizes decrease to a small fraction of their initial sizes, credit risk exposure to individual borrowers may increase significantly. As part of our continuous monitoring of RMBS transactions, we track the evolution of borrower concentration risk and verify that the amount of credit enhancement under a given class of notes always protects this class from the risk of a default by the largest borrowers. If we estimate that the exposure of notes to the largest borrowers is not consistent with their ratings, we will downgrade these ratings accordingly and may withdraw them."

[5] See Moody's Investors Service "Global Structured Finance Operational Risk Guidelines. https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBS_SF397096.

be less likely to occur. The existence of an unrelated third-party that receives the data tapes and checks the originator's systems as part of the servicing agreement, potentially prior to closing of the transaction, can provide additional comfort that the data produced by the originator is reliable (i.e., that the processes and systems are transparent). Furthermore, a third-party servicer gives greater security that the assets will continue to be serviced after an originator defaults, which is much more transparent and predictable than the uncertainty of estimating the impact of an originator defaulting on its servicing capability.

Q3. What are respondents' views on the compliance mechanism and the supervision of compliance presented in this consultative document?

MIS has no views on the compliance mechanism, other than that the following objective laid out by the European Banking Authority (EBA) is important in returning confidence to the market.

The EBA[6] describes the challenge for any compliance setting as follows:

> *"The eventual design of a compliance setting will have to strike the right balance between the objective to clearly defining the system of duties and obligations of investors and originators in determining/proving compliance, so as to ensure prudent and incentive-compatible implementation of the framework, with the need to provide securitization markets with the means of achieving timely and un-controversial compliance determinations".*

Q4. What are respondents' views on the alternative capital requirements for STC securitisation presented in this consultative document?

The rebound of the European securitisation market depends on the alignment of capital charges to those for fixed income instruments more generally. Investors believe that capital charges are not in line with the risk of the instrument and that the current and proposed capital framework attributed to securitisation is out of line with that of covered bonds and the broader fixed income markets.

Improving the standardisation of capital treatment versus other instruments would drive economics and help attract a larger investor base. For example, the MIS 12-month downgrade rate (1984 – 2013) for global structured finance is broadly comparable with that of global corporates (16,6% vs. 15,1%)[7]. Yet it is our understanding that the capital charge against securitisation bonds for investors in Europe is generally significantly higher than that of the comparable risk and maturity for corporate and covered bonds.

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[6] EBA report on qualifying securitisation, published on 7 July 2015.

[7] See Moody's Investors Service Special Comment "Structured Finance Rating Transitions: 1983-2013", 23 June 2014. https://www.moodys.com/research/Structured-Finance-Rating-Transitions-1983-2013--PBC_171245

Increased regulatory stability and cross-jurisdictional consistency would further support a revitalisation of the market. Regulatory stability and the level of operational burden necessary to digest and assess new regulatory information is an important part of an investor's cross instrument relative value analysis. This holds true for all types of investors, but becomes more crucial for smaller ones, in view of limited internal resources. Bigger, multinational investors face an additional layer of complexity to the extent that cross-jurisdictional inconsistencies arise in the regulatory securitisation framework, (for example, divergent criteria for EU STS and IOSCO/BCBS STC). Since multinational investors play an important role in the market, due to their capacity to maintain dedicated and specialized resources, any incremental cross-jurisdictional consistency will support market recovery.