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EU Transparency Register ID Number 271912611231-56

14 January 2015

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Deutsche Bank's response to the European Banking Authority (EBA) discussion paper on simple, standard and transparent securitisations

Dear Mr Farkas,

Deutsche Bank (DB) welcomes the opportunity to comment on the above discussion paper.

DB strongly supports the EBA's view that a one-size-fits-all regulatory approach to securitisations is no longer appropriate. Establishing principles for qualifying securitisations, which would receive regulatory treatment commensurate with their risk reducing simplicity, standardisation and transparency, is a welcome step.

As securitisation markets are global, we believe it is important that efforts are made to establish a global definition of qualifying securitisations. Aligning the work done at the European level with that by the Basel Committee on Banking Supervision (BCBS) and IOSCO joint task force will be crucial.

It has been widely acknowledged that properly regulated securitisation can play an important role in supporting the economy. While there has been encouraging language from policymakers, there are still considerable challenges to the viability of the securitisation markets going forward, including capital requirements, consistent implementation of risk retention rules and regulatory treatment of alternative asset classes with similar risk characteristics. We elaborate on these in the Annex to this letter.

Please let us know if we can provide any further information.

Yours sincerely,

Daniel Trinder
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Deutsche Bank

Annex I - Overarching views

Principles for a qualifying securitisation could be a powerful way to help develop and sustain a stronger securitisation market. Securitisations which meet the eligibility requirements should receive treatment commensurate with reduced risks, in contrast to the current “catch all” regulatory treatment. To be of real benefit to the market, the eligibility criteria needs to be sufficiently broad in terms of sectors included to capture residential mortgage-backed security (RMBS), auto loans, commercial real estate mortgages, leveraged loan collateralized loan obligations (CLOs) and commercial mortgage-backed securities (CMBS).

The consultation paper does not indicate <u>when</u> the criteria for a qualifying securitisation should be fulfilled in order to classify a securitisation as ”qualifying”, For example, should the criteria on XYZ by fulfilled at a specific point in time such as at trade inception or at the beginning of the investment or does the criteria need to be met on an ongoing basis. We believe the most effective solution would be to specify that the criteria must be checked and fulfilled at the time when the bank invests in the securitisation provided that the underlying pool is static. The same holds true for revolving securitisations (where exposures are added to or removed from the pool of exposures) if it is clear that the newly added exposures will also fulfil these criteria.

Annex II – Answers to questions posed in the discussion paper

Question 1: Do you agree with identified impediments to the securitisation market?

While there has been encouraging language from policymakers, there remain considerable regulatory challenges to the viability of securitisation:

a) Capital requirements:

The BCBS recently finalised the capital framework on capital requirements for securitistions held in the banking book and issued a third set of proposals on the trading book. In both cases, the resulting capital requirements are a multiple of capital requirements for the underlying pre-securitised assets. Left unchanged, these rules would substantially reduce the incentives for banks to participate in securitisations and consequently undermine the role securitisation could play in funding Europe’s real economy.

In our view, the best way to calibrate the capital requirements remains as follows:

- As a <u>*first step*</u>, the capital requirement for the securitisation should be limited to a portion of the capital requirement for the underlying exposures, at least for high quality securitisations. This reflects the fact that: i) the pooling of the asset does not change the credit quality of the underlying assets; and ii) securitisations benefit from overcollaterlisation which provides a payment stream in instances of unforeseen losses.
- As a <u>*second step*</u>, for those securitistions which do not qualify as high-quality, the calibration of the different tranches may include a suitable prudential buffer to address model risk and securitisation specific structural features. It is worth noting that model risk is not unique to securitisations, and If the prudence add-on is too high securitisation as a financing technique will be further discouraged
- We recommend that this approach should be replicated for the treatment of securitisations under the Fundamental Review of the Trading Book which is currently under consultation

b) Risk retention

We recognise that risk retention rules are an important element of the regulatory framework to align incentives for investors and issuers as well as restoring trust in the securitisation markets. Properly calibrated, they have real potential to incentivise originators, issuers and investors to conduct quality screenings, improve underwriting standards and adequately monitor for credit risk.

For a vibrant and robust securitisation markets, it is crucial to minimise regulatory inconsistencies. It is therefore important to ensure a level playing field between major jurisdictions originating and trading securitisations. Where risk retention rules serve the same objective of aligning incentives between investors and issuers, mutual recognition of risk retention rules should be granted.

It is our view that retention requirements for qualifying securitisations may not be required, given that: (i) investors are already subject to onerous due diligence requirements before entering into securitisation transactions; (ii) issuers are already subject to significant disclosure obligations under relevant public securities laws (e.g., the Prospectus Directive); and (iii) the types of transactions and level of transparency relating to qualifying securitisations means that such transactions should perform as they are described and understood.

This means there is no longer any misalignment of interests and that any residual retention requirement would simply serve to reduce the effectiveness of the securitisation market. This is the proposed approach taken by the U.S. authorities which waive the retention requirement for securitisation of qualified residential mortgages (QRMs) and in certain circumstances for other asset classes like commercial real estate (CRE), commercial loans and automobile loans.

c) Regulatory treatment of alternative asset classes with similar characteristics

The misperception around securitisation has resulted in disproportionately punitive regulatory treatment of securitisation instruments. The IMF noted[1] that, particularly in Europe, securitisations are unfairly treated asymmetrically vis-à-vis other asset classes, such as covered bonds. This asymmetric treatment could have driven investors to use alternative instruments where securitisation could have provided a better solution to their credit needs and amplify risk concentration in the banking system.

Question 2: Should synthetic securitisations be excluded from the framework for simple standard and transparent securitisations? If not, under which conditions/criteria could they be considered simple standard and transparent?

We disagree with the approach of preventing synthetic securitisations from being considered qualifying securitisations. This blanket approach would remove a large number of securitisations which, from a regulatory policy perspective, would otherwise be eligible.

One example is securitisations of bank loan receivables. Here applicable bank secrecy, data protection and privacy laws prevent the bank from transferring the loans to an SPV. Contractual arrangements that would explicitly authorise the bank to assign and transfer loan receivables to a third party (so-called “asset trading clauses”) may be common in some markets like large caps or auto financing; they are not used in consumer loans and loans to small and medium-size entities (SME). Consumer and SMEs view lending as a sensitive relationship and would normally not accept to face a third party as servicer. Banks use synthetic securitisation to hedge the credit risks stemming from its loan book. Deutsche Bank established well-known securitisation programmes that systematically hedge risks and we consider these programmes as tools for supporting lending to both consumers and corporates.

Another example is securitisations that use two-tiered structures involving two SPVs, where the first SPV holds the assets, the second SPV issues the notes that fund the acquisition of the assets and where the funding is passed-on to the first SPV through a credit linked note. Most U.S. securitisations (including asset-backed commercial paper programs) are based on such a two-tiered structure. The reason for using two-tiered structures is to enhance investor’s rights and the bankruptcy remoteness of the SPVs. The two-tiered structures are usually viewed as true-sale transactions because they use an initial transfer of receivables to the asset holding SPV, which segregates these assets from the originator. The second transfer to the issuing SPV, which is achieved synthetically, should not disqualify these transactions.

[1] IMF Working Paper, Securitistion: Lessons Learned and the Road Ahead, November 2013

We believe that simple synthetic securitisation structures as described in the first example bear a significant advantage with respect to the moral hazard problem involved in the separation of underwriting and risk bearing, which is typical for all forms of risk transfer, if the originating bank can ensure that underwriting staff and credit officers monitoring the exposure do not decide that the risk in fact should be sold via a securitisation transaction. Fulfilling this requirement should qualify a synthetic structure as qualifying.

Question 3: Do you believe the default definition proposed under Criterion 5 (ii) above is appropriate? Would the default definition as per Article 178 of the CRR be more appropriate?

Please refer to AFME's answer to this question

Question 4: Do you believe that, for the purposes of standardisation, there should be limits imposed on the type of jurisdiction (such as EEA only, EEA and non-EEA G10 countries, etc): i) the underlying assets are originated and/or ii) governing the acquisition process of the SSPE of the underlying assets is regulated and/or iii) where the originator or intermediary (if applicable) is established and/or iv) where the issuer/sponsor is established?

Please refer to AFME's answer to this question

Question 5: Does the distribution of voting rights to the most senior tranches in the securitisation conflict with any national provision? Would this distribution deter investors in non-senior tranches and obstacle the structuring of transactions?

Please refer to AFME's answer to this question

Question 6: Do you believe that, for the purposes of transparency, a specific timing of the disclosure of underlying transaction documentation should be required? Should this documentation be disclosed prior to issuance?

Please refer to AFME's answer to this question

Question 7: Do you agree that granularity is a relevant factor determining the credit risk of the underlying? Does the threshold value proposed under Criterion B pose an obstacle to the structuring of securitisation transactions in any specific asset class? Would another threshold value be more appropriate?

Please refer to AFME's answer to this question

Question 8: Do you agree with the proposed criteria defining simple standard and transparent securitisations? Do you agree with the proposed credit risk criteria? Should any other criteria be considered?

<u>Transparency</u>

We believe that private transactions are already subject to the correct level of disclosure and transparency.

The purpose of transparency and disclosure requirements is to allow investors to make an informed assessment of the risks they are taking. Article 409 of the Capital Requirements Regulation (CRR) provides for a fully comprehensive level of disclosure to private investors without disclosing sensitive information to the public that would make these deals unattractive to the investor and hence undermine securitistion issuance.

Private securitisation transactions represent core bank lending facilities similar to the providing of corporate loans. They can help relatively new and fast growing sectors to obtain funding without having to disclose sensitive information to the public. Excluding private transactions outright, on the basis that they are deemed as non-transparent, runs counter to the CRR and may potentially hinder accessing finance for some companies.

Question 9: Do you envisage any potential adverse market consequences of introducing a qualifying securitisation framework for regulatory purposes?

Regulators and policy-makers should give due consideration to the risks that run as a consequence of designation of qualifying securitisations:

- Such designation may provide an implicit subsidy to assets or institutions that qualify easily. Regulators should consider the policy implications of an increased flow of capital to those markets or institutions; and

- It is important to consider what impact establishment of qualifying securitisations will have on perception of non-qualifying securitisations. We see it as necessary to support more junior tranches of safe and robust securitisation markets. In this regard, continuing to help improve the availability of data and analytics and seek to ensure that these are delivered as efficiently as possible, is key.

Question 10: How should capital requirements reflect the partition between qualifying and non-qualifying?

Please refer to our answer to Question 1.

Question 11: What is a reasonable calibration across tranches and credit quality steps for qualifying securitisations? Would re-allocating across tranches the overall capital applicable to a given transaction by reducing the requirement for the more junior tranche and increasing it for the more senior tranches other than the most senior tranche be a feasible solution?

Please refer to AFME's answer to this question

Question 12: Considering that rating ceilings affect securitisations from certain countries, how should the calibration of capital requirements on qualifying and non-qualifying securitisations be undertaken, while also addressing this issue?

Please refer to AFME's answer to this question

Annex III – Other comments

Commercial Mortgage Backed Securities (CMBS)

We support the EBA's view that any simple, transparent and standard securitisation, backed by high quality underlyings, should be considered as potentially being of high quality regardless of asset class. However, due to a number of the proposed criteria, all Commercial Mortgage Backed Securities (CMBS) appear to be excluded.

Commercial mortgage loans are a significant asset on the balance sheets of many banks. In order to give these banks alternative financing sources and to enable them to provide commercial property finance without having to increase their balance sheets it is important that there be an active CMBS market. This is particularly true where traditional bank lenders are substantially shrinking their balance sheets and are therefore reluctant to provide such finance if the loans have to be funded through their balance sheets.

We see the following proposed criteria as leading to the exclusion of CMBS from being recognised as being simple, standard and transparent, regardless of the quality of the underlying assets underpinning those securitisations:

Critical

Full recourse to a non-SPV Borrower/Obligor (Criterion 4(iv)(a))

- No prudent owner of commercial real estate borrows on the basis of a full recourse to a non-SPV borrower/owner.
- As this is the standard bank loan, loans that are originated for CMBS or that banks might want to finance through CMBS will be full recourse to SPV borrowers.
- The only exceptions to this are those owners who by virtue of their legal form have no alternative, for instance, German open ended funds.
- It is worth noting that the entire US commercial mortgage market (CMBS and non-CMBS) works on the same basis in terms of the structure of the borrower.

Loans must be fully amortising (Criterion 4(iv)(b))

- With very few exceptions (and these are mostly in the UK) capital markets, term commercial mortgage bank loans are partially amortising with significant balloon principal payments at maturity. The term to maturity at origination is usually 10 years or less and most often around 5 years.
- Given that this is the bank market standard loan in Europe, CMBS will contain loans that have the same features.
- Most corporate loans and corporate bonds are not fully amortising. In this respect commercial mortgage lending simply follows the same format as general corporate lending.

Serious Impediments

Fiduciary ("identified person") to settle differences between classes of bonds (Criterion 13)

- There exist established procedures within CBMS that balance the interests of the various classes of debt which are not always aligned. These procedures and mechanisms have been developed on the basis of input by investors at the time of marketing CMBS – CMBS investors have input into the structure of the CMBS that they are being asked to buy. We believe that these procedures are a good base for settling differences between classes of bonds.
- The "identified person" is meant to be a fiduciary, but that is not permitted as they cannot fulfill the duties of a fiduciary for each class of bonds.
- The Condition states that the voting rights of the bond holders have to be given to the most senior class of bonds. This means that all junior classes become unsaleable – certainly the market solution to this problem in the CMBS market balances the interests of the various classes.

5 Years of performance on similar loans (Condition 20)

- The purpose of the extensive disclosure in CMBS is to allow investors to underwrite thoroughly the very small number of loans in the CMBS if they choose to – this is something that cannot be done in ABS with large numbers of loans/receivables.
- For those ABS where investors cannot underwrite each loan, investors have to rely on pool statistics and the historical performance of loans originated by that originator. This is clearly a second best situation but is the only practical path.
- Commercial mortgage loans are generally inherently bespoke and so a requirement to identify "similar loans" and show their performance over 5 years involves the sponsor choosing what loans are "similar". Is a 60% LTV office loan in central London originated at the bottom of the market in 2009 or 2010 the same as the same loan at the same LTV originated in 2007 at the top of the market? If the sponsor has chosen the set of "similar" loans it is not clear that investors will consider that a reliable benchmark

- There is a risk that lenders wishing to enter a lending market in which loans are priced expensively may not be able to enter that market and use CMBS either as a derisking or a funding method.