Introduction and Overview of PCS Principles

1. Introduction and Summary

The EFR and AFME / ESF, in collaboration with the EBF, EFRP, EFAMA and CEA are exploring the applicability and merits of a market-led initiative aimed at expanding the participation of currently active investors as well as attracting investors who are not currently investing in securitised product. In October 2009, the EFR and AFME/ESF, established a Steering
Committee\textsuperscript{1} comprised of representatives of key types of securitisation market stakeholders – investors (represented by a fund manager, two insurance companies and one pension fund), issuers, traders and arrangers. Central to this initiative, termed the ‘Prime Collateralised Securities’ (PCS)\textsuperscript{2} initiative is the establishment of a defining and broadly new set of market conventions, adoption of which might extend and improve the functioning of the securitisation market without requiring the pre-condition of government financial support. The key high-level \textbf{principles} of this initiative are: quality, transparency, simplicity/standardisation and liquidity, which are consistent with the principles proposed by the ECB. In particular, simplicity and standardisation are frequently cited as goals by investors. However all securitisations will inevitably involve some level of cash flow allocation and therefore will include at least some element of complexity. In summary, the goal for PCS is to encourage issuance of securitisations backed by diversified pools of “real economy” assets through structures which are more standardised. Products such as resecuritisations are therefore excluded from the scope of PCS.

2. Main Features of the PCS Initiative

The \textbf{market convention} would:

\textbf{2.1} Lay out the \textbf{criteria} that must be fulfilled in order to be PCS-compliant. Such criteria will be regularly reviewed and periodically amended to ensure alignment with current market conditions. These requirements relate to:

a. The definition of acceptable real economy assets as well as acceptable structures
b. Homogeneous standards for quality, simplicity/standardisation, transparency and liquidity, and
c. Promotion of conditions and organisational market features to enhance market liquidity

\textbf{2.2} Create a \textbf{label} that would be granted to PCS-compliant issues so as to allow market parties to easily identify those securitisations that comply with the above standards. The PCS label is not intended as a replacement for credit analysis or due diligence but rather a tool for market participants to know that the information to be provided on an ongoing basis complies with agreed standards.

\textbf{2.3} Include appropriate \textbf{oversight and governance} of the initiative for:

a. Initial and ongoing eligibility for use of the label, and
b. Any changes to eligibility criteria for use of the label

\textsuperscript{1}The ECB and EIB Group participated as observers, but have not taken any position with respect to this initiative.
\textsuperscript{2}Please note that ‘PCS’ is a working title.
2.4 Set the principles and requirements that need to be fulfilled by market participants for **eligible high quality underlying assets**, which will initially be: corporate lending (i.e. diversified secured and unsecured SME loans and leases, operating large corporate loans and leases), including trade receivables and consumer assets (auto, consumer and personal loans and leases, credit cards), and residential mortgages. Securitised asset pools would need to meet these eligibility criteria in order to be granted the label. Criteria would be tailored to asset classes and, when needed, to jurisdictions. Other asset classes may be added later as the initiative develops.

3. Implementation and Governance
The PCS initiative would have implementation monitored by appropriate oversight and governance. It is proposed that this is implemented by an independent market committee body to establish and periodically update the market convention (a **PCS Market Committee**), and an industry-funded administrative body such as a secretariat (a **PCS Secretariat**), which would, inter-alia, be responsible for granting and withdrawing the PCS label. Such oversight and governance could also benefit from self-certification and third party audits.

The **label will be granted** provided that the eligibility criteria are fulfilled on an ongoing basis based on the information provided at time of deal launch and during the duration of the transaction. The label would be withdrawn in all cases where there is a failure by counterparties (i.e. the originator/issuer) to comply with the requirements set by the PCS. For example, changes to underlying credit performance or rating changes will not be grounds for withdrawal of the label.

4. The Four Standards: Quality, Simplicity/Standardisation, Transparency, and Liquidity
4.1 Origination/Underwriting Quality Standards

a. **Origination Channels and Processes**: The ‘quality standards’ would lay out, inter alia, eligibility criteria for the origination process

b. **Eligibility Criteria for Underlying Assets**: Eligibility criteria would vary for each asset class, with EU-wide common standards as well as country exceptions

Ratings: The labelled securities would be senior classes rated AAA by at least two rating agencies.
4.2 Simplicity/Standardisation: The overall aim of this principle would be to attempt to promote adoption of common standards to ensure that securitisation issues backed by similar collateral and originated in the same jurisdiction would be comparable, with the intent that investors could more easily analyse differences between various transactions.

4.3 Transparency Standards: While taking into account the ongoing work of IOSCO, CESR, central banks and other regulatory/supervisory bodies, the objective would be to ensure that existing and investors and potential investors are in a position to easily and regularly monitor the performance of underlying collateral (provision of loan-by-loan detail and transaction cash flow models, and disclosure of underwriting and servicing criteria) based on a common set of information agreed with investors and originators and with the support of arrangers. The level of originator disclosure would comply with relevant legislation and regulation.

4.4 Improving Secondary Market Liquidity Standards: An important condition to restoring confidence in the primary securitisation market is the improvement of secondary market liquidity. The objective is two-fold: to take appropriate measures to foster the regular and sustainable participation of a large and diversified investor base, and secondly to create the conditions for sustainable market-making, under normal and stressed conditions. To facilitate trading of PCS securities, the PCS Market Committee will also be engaged to incentivise over time the conditions and organisational market features to promote a liquid secondary market. For example, this includes endorsement of specified trading activity on one (or a few) eligible platforms or multilateral trading facilities, and improved transparency in any conditional market making arrangements, which could include two-way prices, especially for benchmarks. PCS would support other proposals to improve liquidity, such as:
   a. Minimum transaction size
   b. Minimum number of book runners
   c. Listing on an eligible stock exchange
   d. Trading on a regulated market
   e. Preferential treatment for PCS-eligible securities under relevant trading-related regulatory rules
PCS Term Sheet Highlights

(Please note that these highlights are subject to further review after the survey results are completed by investors and then later by issuers)

The market convention should initially target certain eligible high quality underlying assets, including:

- Corporate lending (i.e. diversified secured and unsecured SME loans and leases, large corporate loans and leases), including trade receivables
- Consumer assets (i.e. auto, consumer and personal loans and leases, credit cards)
- Residential mortgages

A. Quality Standards and Eligibility Criteria

(Please see an Example in the Appendix)

1. Eligibility Criteria for Origination and Servicing Process - Transaction Counterparties

1.1 Ratings
The labelled securities would be senior classes rated AAA by at least two rating agencies or such other rating requirements as may be required in the future by the ECB for its Collateral Framework. The minimum rating of the country where the receivables are originated must be consistent with ECB and Bank of England standards.

1.2 Origination Channels, Criteria and Recovery Processes
The origination of the receivables may be delegated to third parties (broker, etc.), with the originator representing that the receivables were originated in accordance with the underwriting criteria of the originator. Also disclosed would be relevant underwriting, administration, collection and recovery processes, including the use of existing central/national databases when relevant, the checks done on borrowers, etc.

1.3 Servicing Processes/Back-Up Servicing
The offering circular shall include a description of the servicing process, including the procedure and circumstances requiring the implementation of a back-up servicer or in the
contracting of another back-up servicer when applicable. The servicer shall represent and warrant that it will service the receivables to the same standards used for its unsecuritised receivables.

1.4 Identity and Quality of Counterparties
Counterparty and commingling risk would be monitored and mitigated, if needed. Requirements for appointment of a back-up servicer, if appropriate, must be clearly disclosed.

1.5 Originators’ Undertakings and Portfolio Audits
Issuers would provide representations and warranties on the initial portfolio and for additional portfolios added to the pool in the case of revolving portfolios. Any commitment by issuers to repurchase assets or provide indemnification in respect of these representations and warranties shall be disclosed. Initial audits would verify:

a. A sample of pool tapes against the origination databases
b. Pool statistics in the prospectus and
c. Expected weighted avg. life of the notes and the model assumptions used.

Periodic ongoing audits would include:

a. A performance report (annual)
b. A payment report (annual)
c. A servicing procedure report. Failure to perform an audit, or an unacceptable audit result would result in withdrawal of the label, if the failure is not remedied

2. Eligibility Criteria for Underlying Assets
These highlights refer to assets originated in the European Union. Eligibility criteria would vary for each asset class, with EU-wide common standards as well as country exceptions. An example of eligibility criteria for SME Loans is included in the Appendix. For example, guidance would be set on the following types of characteristics (among others): minimum transaction size, maximum loan size, minimum number of loans or obligors, maximum obligor concentration, residual values, balloon payments, payment frequency, payment method, maximum debt service payment as a percentage of income, loan to value ratio etc.
3. Eligibility Criteria for Originators

All consumer/retail loans would be originated by an originator appropriately licensed or regulated in its respective jurisdiction, each adhering to home country regulatory requirements with the exception of corporate issuers that are generally not regulated. Broker-originated assets are permitted if the originator represents that the assets are originated by the broker in accordance with the originator’s underwriting standards.

B. Standardisation/Simplicity of Structures

1. Standardisation/ Simplicity

1.1 Standardisation of Structures

Eligible structures are cash-funded discrete and revolving pass-through or bullet structures as well as master trust structures meeting, inter alia, the asset eligibility criteria. The aim is to ease the analysis of securitisation bonds by market participants and ultimately to increase secondary market trading by encouraging simplification and standardisation of structures, as well as ongoing disclosure of information, including detailed cash flow models. Structures may include call and put features. No resecuritisations are permitted (no CDO squared nor CDOs of ABS).

1.2 True Sale Criteria

The securitised assets and ongoing cash flows must be transferred to a special purpose vehicle or legally isolated pursuant to a valid, binding and enforceable assignment, sale or grant of a security interest in accordance with a “true sale” standard or similar legal equivalent, depending on the laws of the local jurisdiction.

1.3 Credit Enhancement

Internal/intrinsic credit enhancement mechanisms would be eligible such as overcollateralisation, subordination, excess spread and cash reserves. Eligible credit enhancement providers or guarantors in order for the required rating to be achieved are limited to: supranational entities, public entities, banks or government entities and regulated insurance companies.
1.4 Other Structural Features

Regulatory, tax, clean up and mandatory calls would be eligible. Waterfalls and triggers must all be clearly disclosed. Interest rate and currency hedges in the structure would need to be disclosed. Structures may include a time call, clean-up call, liquidity put or step-up margin, mainly to manage the extension risk.

2. Standardisation of Legal Documentation

2.1 Standard Definition of Credit Performance Measurements

Definitions for the measurement of the performance of the assets would be disclosed. To the extent available, Basel 2 definitions for relevant measures such as those for delinquent receivables and defaulted receivables should be used.

2.2 Standardised Definitions

Definitions of commonly used terms within a given country will be developed and agreed by [31 Dec 20_] and implemented by [31 Dec 20_].

C. Transparency Standards

While taking into account the ongoing work of IOSCO and CESR, the objective should be to ensure that investors and potential investors are in a position to easily analyse and regularly monitor the performance of underlying collateral (provision of loan-by-loan detail and transaction cash flow models, and disclosure of underwriting and servicing criteria) based on the standardised definitions mentioned above. The level of originator disclosure would comply with relevant legislation and regulation.

1. Requirements for Originators

1.1 Industry Reporting Best Practices

The Originator would be responsible for describing and disclosing in the offering documents the underwriting channels and criteria used to originate securitised assets, including relevant underwriting, administration, collection and recovery processes, including the use of databases when relevant, credit assessment methodologies utilised, income verification of borrowers, etc. The identity of third parties whose counterparty
credit risk is factored into the rating of the issue (account bank, paying agent, liquidity and swap providers etc.) shall be disclosed. Any caps on liquidity exposure provided by the sponsor/book runner will be disclosed. In addition, originators/issuers must agree to comply with relevant industry issuer best practices for transparency and standardisation in upfront and ongoing data reporting, including standardised definitions to be developed on an asset class by asset class basis by jurisdiction in accordance with industry best practices. For RMBS, this would include compliance with already-developed industry RMBS issuer principles no later than an agreed date.

1.2 Transaction Information Summary

A simple and informative template in English would be prepared and signed upfront by the originators who provide the key transaction information in accordance with PCS requirements, in compliance with relevant European laws and regulations.

1.3 Modelling Inputs

In the first stage of PCS, in order to facilitate the analysis and valuation of PCS transactions, the originator/issuer would make available a summary of key structure characteristics, including, for example, asset data (e.g. pool tape) and liability data (e.g. standardised cash flow waterfall and performance triggers). This information will be made available to interested parties, including third party vendors who offer to make available a cash flow model (on a fee or no fee basis). Cash flows models could be provided by the originator as well. This information should include an agreed set of relevant parameters/inputs such as constant prepayment rates, default rates, arrears, subject to the requirements of the Prospectus Directive.

1.4 ECB/Bank of England (BOE) Loan by Loan Reporting

PCS disclosure standards are expected to include ECB and Bank of England requirements regarding information to be made publicly available. This would include compliance with ECB and BOE requirements on loan-by-loan reporting (LBL) for the relevant asset classes for which LBL reporting is required (to the extent currently feasible at the time of issuance). These requirements are expected to be in force during the course of [20 [11]]. This information will need to be made available by originators/issuers and will be distributed to market participants as well as the PCS Data Portal as described herein.
2. Data Accessibility

PCS Data Portal and Data Access System
In a second stage of PCS, a data portal would be created with respect to PCS securities by the PCS Secretariat, as a publicly-accessible database in which stakeholders would obtain:
   a. Comprehensive list of all outstanding securitisations, by ISIN
   b. Access to pool composition and updated performance statistics for both assets and liabilities of each PCS, as of the most recent data report
   c. A directory of vendors providing modelling services for each ISIN
   d. A directory of vendors providing valuations on each ISIN
   e. Some type of time-delayed post-trade information, taking into account relevant regulations

3. Minimum Pre-Marketing Period
Transactions would have a minimum marketing period of no less than one week between the distribution of transaction materials (marketing documents, cash flow models etc) and the pricing date.

   D. Liquidity Standards

Liquidity-Enhancing Business Practices
There are a number of proposals that may be adopted to improve liquidity, which could include a minimum size of each AAA tranche, a minimum number of lead managers, as well as transactions being listed on an eligible EU stock exchanges and trading on an EU regulated EU market and/or MTF.

E. Implementation of the Market Convention

1. Governance and Monitoring/Compliance
Effective implementation of the market convention is important. Two approaches could be implemented:
   a. A self-certification process with some type of third party audit verification, or
   b. Establishment of an industry self-regulatory body, such as a PCS Market Committee and a PCS Secretariat administrative body with separate employees.
The PCS Market Committee (PCSMC) would be in charge of:

a. Monitoring market developments;
b. Establishing and reviewing the market standards, regularly adapted to market conditions;
c. Reviewing the criteria for the acceptability of eligible participants. The PCSMC would amend the provisions of the convention in accordance with the terms of the code of conduct of the PCS.

The PCS Secretariat would establish and monitor the day-to-day management of the label, the process of which would be streamlined so issuers can quickly access markets. Its main functions would be to grant, withhold or withdraw the label on the basis of the criteria and requirements in the market convention:

a. Make available in electronic format the information memoranda of labelled programmes and related information on a publicly-accessible website;
b. Provide certain data to the eligible data providers to produce statistics;
c. Act as the secretariat to the PCSMC;
d. Maintain the register of names of eligible participants;
e. Maintain a list of accredited market makers/joint lead managers which will need to adhere to any form of conditional market-making agreement adopted\(^3\);
f. Design an arbitration process for investors and issuers, including any audit disputes and

g. Administer the PCS market website.

2. Conditional Market Making

The objective is two-fold: to take appropriate measures to foster the regular and sustainable participation of a large and diversified investor base, and secondly to create the conditions for sustainable market-making, under both normal and stressed conditions. Consideration must be given to the interaction between the primary and the secondary markets, as well as increasing secondary market trade transparency. Within an agreed short time period after its establishment, the PCSMC will be mandated to endorse an action plan, with a precise timetable, to achieve the objective of improving market liquidity, taking into consideration the conclusions of the IOSCO Consultation Report on Transparency of Structured Finance Products to build a more efficient market.

\(^3\) In the case of a market-maker failing to comply with the market-making obligation, the market-maker will be (temporarily) removed from the list.
2.1 All parties acknowledge and recognise that improving market liquidity is a key objective.

2.2 All parties acknowledge and recognise that improvements in secondary market liquidity are a desirable outcome.

2.3 It is also acknowledged that under current market practices, provision by bank dealers of liquidity is voluntary. Some form of market making arrangement should be considered to be introduced; however, these arrangements are likely to include important conditionality to such market making. There are a variety of potential liquidity-enhancing alternatives that could be provided by originators and investors. Policy and regulatory incentives that would encourage market-making arrangements for PCS transactions include:
   a. ECB Repo Eligibility with favourable haircuts as compared to non-PCS
   b. CRD Prudential Capital Requirements: PCS eligibility for bank liquidity book ratios, treatment of trading books re market making/trading/liquidity
   c. Solvency II Prudential Capital Requirements: PCS favourable capital treatment
   d. Increased Participation by the EIB for SMEs: purchasing, guaranteeing or providing liquidity for SME PCS (see Appendix for example of eligibility criteria for SMEs)

2.4 Other features under consideration/discussion in order to increase potential liquidity would include: originators playing a role (such as defining a minimum and maximum level of the amount that the originator may issue/auction directly to dealers/investors who are dealing on selected trading platform(s)); investors contributing liquidity through repo mechanisms, and finally, the establishment of infrastructures to foster liquidity, particularly in the repo market.

2.5 In addition to the crucial incentives for book runners to make markets, a means to promote market liquidity is increased usage of electronic trading platforms. Trading on electronic trading platforms (ETFs) would be encouraged to the extent that it improves liquidity for investors and dealers. The convention should define the acceptability criteria for the market operators (MTFs/exchanges). **Acceptable markets:** It is expected that market operators would:
   a. Be MiFID-compliant
   b. Satisfy post-trade transparency requirements (to be determined)
c. Provide easy access to data portal and valuation information

d. Allow the collection of information in order to provide ranking on an aggregate basis for the PCS market

e. Allow interconnections with the repo market, and,

f. Compile or be conducive to the compilation of a PCS bond index
# Appendix -

## Illustrative Asset Eligibility Criteria for SME Loans

### SME Loan Portfolio Requirements

<table>
<thead>
<tr>
<th>Parameters</th>
<th>SME loans</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Exposure Eligibility</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Obligation Characteristics</strong></td>
<td>Senior secured and unsecured.</td>
</tr>
<tr>
<td><strong>Origination Channel</strong></td>
<td>Originated by the originator itself in accordance with its standard underwriting and origination criteria and procedures at the time of origination.</td>
</tr>
<tr>
<td><strong>Loan Subsidies / Contributions</strong></td>
<td>No</td>
</tr>
<tr>
<td><strong>Loan Syndicated</strong></td>
<td>No</td>
</tr>
<tr>
<td><strong>Revolving Credit Facility</strong></td>
<td>Maximum 30% exposure to revolvers</td>
</tr>
<tr>
<td><strong>Planned Payment Holiday</strong></td>
<td>No</td>
</tr>
<tr>
<td><strong>Currency</strong></td>
<td>EUR or GBP (all loans in the portfolio have to be denominated in the same currency)</td>
</tr>
<tr>
<td><strong>Payment Method</strong></td>
<td>Direct debit</td>
</tr>
<tr>
<td><strong>Payment Frequency</strong></td>
<td>No less frequent than quarterly, with no more than [15]% permitted to be up to semi-annual</td>
</tr>
<tr>
<td><strong>Min Installment Paid</strong></td>
<td>2</td>
</tr>
<tr>
<td><strong>Secured Loans collateral</strong></td>
<td>Real estate underling asset should be fully constructed</td>
</tr>
<tr>
<td><strong>Max Remaining Term (Secured)</strong></td>
<td>20 yr</td>
</tr>
<tr>
<td><strong>Max Remaining Term (Unsecured)</strong></td>
<td>No more than [ ]% greater than 10 years</td>
</tr>
<tr>
<td><strong>Obligor Eligibility</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Obligor</strong></td>
<td>Legal entity other than public entity which is not a group entity of the originator</td>
</tr>
<tr>
<td><strong>Obligor relationship with originator</strong></td>
<td>Obligors must have been originator's customers for min of one consecutive year</td>
</tr>
<tr>
<td><strong>Obligor Geographical Concentration</strong></td>
<td>At least 90% of obligors in the portfolio resident in the same country</td>
</tr>
<tr>
<td>Obligor Arrears*</td>
<td>Not in arrears for more than 60 days during the 12 months immediately prior to transfer date and not in arrears at the cutoff date</td>
</tr>
<tr>
<td>-----------------</td>
<td>----------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Obligor Securitised Amount</td>
<td>A minimum amount of originator retention will be required in order to ensure alignment of interests.</td>
</tr>
</tbody>
</table>

**Portfolio Credit Quality**

<table>
<thead>
<tr>
<th>Portfolio Credit Quality</th>
<th>In line with or better than the whole originator’s portfolio at the time of closing.</th>
</tr>
</thead>
<tbody>
<tr>
<td>WA Coefficient of Variation of the underlying loans 1y PD (i.e. standard deviation/mean)</td>
<td>$&lt; 100%$</td>
</tr>
</tbody>
</table>

**Portfolio Concentration**

<table>
<thead>
<tr>
<th>Max Obligor Group Concentration</th>
<th>0.5%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Min Effective Number (EN) of obligor groups**</td>
<td>500</td>
</tr>
<tr>
<td>Max Obligor Industry Concentration***</td>
<td>20%</td>
</tr>
<tr>
<td>Min SME (as per the European Commission definition) portfolio obligors</td>
<td>70%</td>
</tr>
<tr>
<td>Max Bullet or Balloon</td>
<td>30% (if the portfolio weighted average residual maturity $&gt; 2$ yrs)</td>
</tr>
<tr>
<td>Max Exposures Originated in One Calendar Year</td>
<td>30% (if the portfolio weighted average residual maturity $&gt; 2$ yrs)</td>
</tr>
<tr>
<td>Max Difference between portfolio WAL and Loan WAL</td>
<td>$[\cdot]%$</td>
</tr>
</tbody>
</table>

*The obligor must not have become insolvent or subject to winding-up, administration or analogous proceedings and must not have restructured any of its debts.

$$
\frac{1}{N} \sum_{i=1}^{N} \left( \frac{a_i}{A} \right)
$$

** Calculated using the following formula: $EN = \frac{1}{N} \sum_{i=1}^{N} \left( \frac{a_i}{A} \right)$ where $a_i$= outstanding amount obligor group $i$ and $A$= total portfolio outstanding amount;

*** As per agreed industry classification