EUROPEAN BANKING AUTHORITY

Significant Risk Transfer in Securitisation

Public Hearing, EBA premises, 17 November 2017

Mandate & Structure of EBA work on SRT

Mandate:

- Extended mandate in the new CRR (Art. 243(6) and 244(6))
- EBA to monitor range of supervisory SRT practices
- Focus: conditions for transfer of credit risk; interpretation of commensurate transfer; requirements for CAs’ assessments

Structure of EBA work:

- Regulatory treatment of SRT and EBA mandate
- Overview of market and supervisory practices with respect to SRT
- **EBA proposals in three core areas:**
  - **Process of SRT assessment**
  - **Structural features of SRT transactions**
  - **Quantitative SRT tests**
- **Regulatory treatment of NPL securitisation**

FOCUS OF DISCUSSION TODAY

EBA proposals

Heterogeneity of supervisory practices on recognition of SRT

Partially reflecting limitations/lack of regulatory treatment

Possibly leading to weakened capital positions, increased regulatory uncertainty and impairment of level playing field

Goal to enhance and harmonise regulatory and supervisory treatment

1. Process of SRT assessment		2. Complex structural features		3. Quantitative SRT tests	
SRT notification by originator to CA	Originator's feedback on achievement of SRT	Safeguards for each structural feature	Risk transfer self-assessment	Option 1: Enhance-ment of existing tests	Option 2: new test to supplement/ replace the existing tests

1. Process of SRT assessment

Objective: Facilitate the SRT process for both originators and CAs

Proposal: Standardisation in 4 areas

Ex ante notification of SRT transaction by originator to CA	• At the latest 1 month before expected issuance • Final documentation 15 days after the closing date
CA's feedback to originator	• Explicit feedback on SRT achievement: • statement of non-objection/objection to the transaction • Within reasonable timeframe after submission of final documentation
Additional notifications by originator to CA	• Changes in the characteristics of the transaction impacting on the transferred risk • Exercise of call options • Application of full deduction option • Ongoing monitoring of SRT compliance, quarterly
Amended version of SRT monitoring template	• Insertion of guidance/additional points

2. Structural features

Objective: Ensuring sustainability of the SRT throughout the lifetime of the transaction

Proposal:

A. Specific conditions/constraints for the following complex structural features:

For traditional or synthetic transaction:

- Pro-rata amortisation
- Call options
- Excess spread

For synthetic transaction:

- Credit events
- Termination clauses
- Cost of credit protection

B. Self-assessment exercise (stress test) to quantify the extent of risk transfer on a lifetime basis:

In case of traditional transaction:

- When including structural features

In case of synthetic transaction:

- Always

2A. Conditions/constraints for structural features: for both traditional and synthetic transactions

Pro-rata amortisation	Call options	Excess spread

• **Contractual triggers for a switch to sequential priority:**
  • Cumulative losses higher than % of lifetime EL
  • Cumulative non-matured defaults higher than % of the sum of the outstanding nominal amount of the protected tranche and the tranches subordinated to it
  • Weighted average credit quality in the portfolio decreasing below a specified level and/or concentration of exposures in high credit risk (PD) buckets increasing above a specified level
  • Granularity of the portfolio falling below a specified level
• **Taken into account in self-assessment**
	• **Regulatory call options:**
	  • Changes in law/regulation, or official interpretation by authorities (incl. taxation and accounting provisions)
	• **Time calls:**
	  • In traditional securitisation: hindering SRT
	  • In synthetic securitisation: not hindering SRT if exercisable after the WAL of portfolio
	  • Should not be structured to provide credit enhancement
	  • **SRT calls:**
	    • Not hindering SRT
		• **In synthetic securitisation:**
		  • Commitment to a fixed nominal amount of excess spread available on yearly basis
		  • Only in trapped mechanism
		  • Consideration in quantitative tests as 1250% RW/capital deduction
		  • Total excess spread amount committed on a yearly basis lower than 1 year EL
		• **In traditional securitisation:**
		  • No fixed (pre-determined) level of excess spread
		• **Definition of excess spread in documentation**
		• **Taken into account in self-assessment**
		• **Consideration of Pillar 1 own funds requirement on future excess spread in synthetic transactions**

2A. Conditions/constraints for structural features: for synthetic transactions

Cost of credit protection	Other early termination events	Credit events

• Premiums structured as **contingent premiums**
• Taken into account in **self-assessment**
• Documentation to include **all relevant information** used to price the credit protection contract
	• **Failure to pay, breach of material contractual obligation, illegality arising from a contractual obligation:**
	  • Not hindering SRT
	• **Originator's bankruptcy:**
	  • Could hinder SRT
		• At least the following credit events to be foreseen:
		  • **Failure to pay**
		  • **Bankruptcy**
		  • **Restructuring**

2B. Risk transfer self-assessment

Quantitative self-assessment of risk transfer to be submitted to CA

Evidence as to how total losses absorbed by investors as a % of total losses in the transaction and the portfolio over the lifetime of the transaction compare to:

- The average reduction of RWEAs incurred by the originator post-securitisation
- The total losses expected to arise over the lifetime of the transaction

Include at least the following elements:

- A base case and a stress scenario of PD and LGD of underlying exposures
- A base case and a stress scenario regarding the timing of the realisation of the losses
- A base case and a stress scenario regarding the portfolio's behaviour in terms of pre-payments
- A base case and a stress scenario regarding the availability of excess spread
- Amortisation structure, including the sequential amortisation triggers
- The stream of credit protection premiums and credit protection payments (if synthetic)
- Any time call (if synthetic)

Carried out on the basis of the transaction's cash flow model

3. Quantitative SRT tests

Objective:

Reflecting underlying rationale of the existing texts:

- Focus on measuring of significance of transferred risk
- Reflection of EL and UL assumptions under the credit risk framework

Addressing identified limitations of the existing framework:

- No clear safeguards for sufficient **thickness of relevant tranches**
- No requirement to assess the **sustainability** of the SRT
- Limited focus of **commensurateness** of the transferred risk
- No further interpretation of **‘substantial margin’ and ‘reasoned estimate’**

Respond to new CRR mandate:

- To interpret the **‘commensurateness’** of the risk transfer

3. Quantitative SRT tests – cont.

Proposal: 2 options:

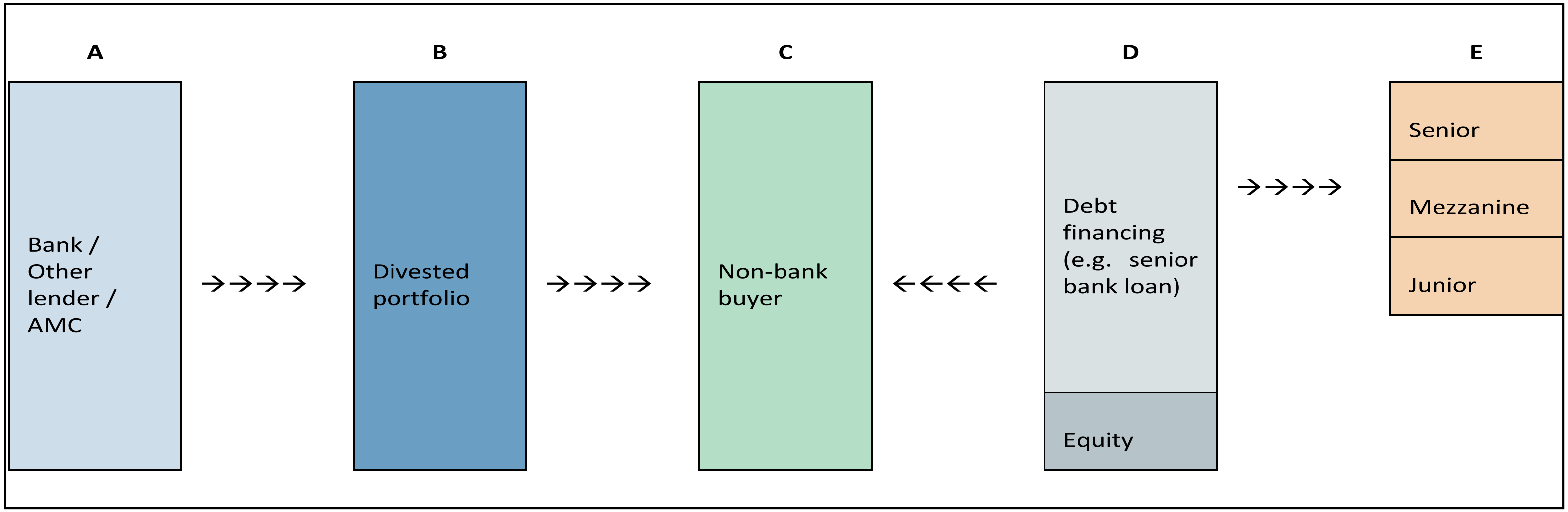
Option 1: Complementing the existing tests

- **Minimum thickness of first loss tranche:**
  - In case of both first loss and mezzanine tests
  - 1^{st} loss test: 1^{st} loss tranche + lifetime excess spread ≥ Lifetime EL + 2/3 Reg. UL
  - Mezzanine test: 1^{st} loss tranche + lifetime excess spread ≥ Lifetime EL
- **New test of commensurateness:**
  - Ratio of capital reduction achieved by originator ≤ ratio of risk transferred to third parties
  - $\frac{(capital\ pre\ sec\ including\ EL)-(capital\ post\ sec.on\ retained\ pos.)}{(capital\ pre\ sec\ including\ EL)} \leq \frac{(Lifetime\ EL+reg.UL\ on\ transfered\ pos.)}{(Lifetime\ EL+reg.UL\ of\ the\ underlying\ portfolio)}$

Option 2: New test, complementing/replacing the existing tests

- **Test of significance/commensurateness:**
  - Risk retained by originator (post-sec own funds requirements) + 1 year excess spread ≤ sum of EL and 50% of UL on the securitised portfolio
  - When SEC-ERBA is used: min 95% of positions attaching below KA that are not 1250% risk-weighted/deducted to be transferred to third parties

4. NPL securitisation

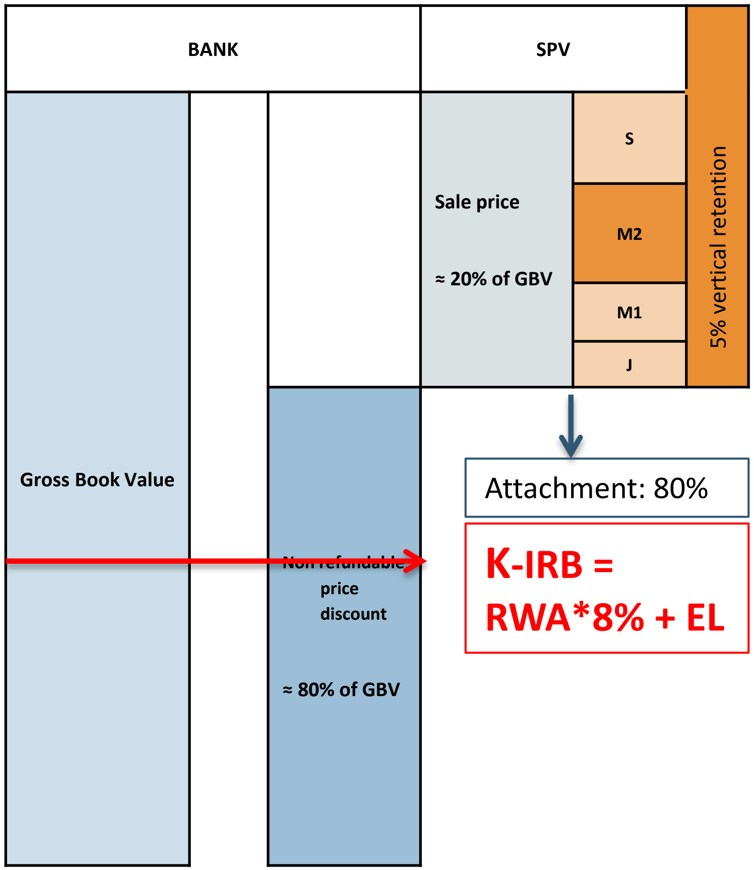


- **Direct bank's securitisation:** The originator sells the NPL/non-core portfolio, or part of it, to a securitisation vehicle, which issues securitisation notes fully or partly placed with third party investors (steps A + E)
- **Portfolio sale to non-bank investor**: the originator sells the NPL/non-core portfolio to a non-bank investor, who purchases using its own capital (steps A+B+C) or partly leveraged through debt finance (e.g. senior bank loan, steps A+B+C+D), only keeping an equity stake.

Question

- **Are these the prevailing models of NPL securitisation? Do you foresee these models will work under the new legislative framework?**

4. NPL securitisation



- In an NPL transaction with non-refundable PPD, K-IRB is fully or almost fully covered by such losses absorbed by the originator at or before the time of sale;
- Only the Sale Price volume is securitised in the SPV (although underlying loans sold to the SPV are obligations for the GBV)
- A comprehensive view of portfolio risk, looking at GBV, should acknowledge that tranche ‘J’ attaches at 80%, not 0%;
- I.e. provisions and non-refundable PPD act as credit enhancement to the securitisation (at least covering whole EL);
- **Risk weight on securitisation tranches is NOT 1250%, as if the securitisation was looked at in isolation from portfolio GBV**

Questions

- **Do the recommendations on the SRT assessment of complex structural features equally apply to NPL securitisation transactions?**

- **Is commensurate risk transfer relevant to NPL securitisation transactions?**

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