

EBA/CP/2016/01

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20 January 2016

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# Consultation Paper

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Draft Guidelines

on implicit support under Article 248(2) of Regulation (EU) No 575/2013

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# 1. Responding to this consultation

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The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions summarised in 5.2.

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

## Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 20.04.2016. Please note that comments submitted after this deadline or submitted via other means may not be processed.

## Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

## Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) N° 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the Legal notice section of the EBA website.

## 2. Executive Summary

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Pursuant to Article 248 of Regulation (EU) No 575/2013 ('CRR'), restrictions are placed on providing implicit support to securitisations. Originator institutions and sponsor institutions having failed to comply with the relevant requirements shall at a minimum hold own funds against all of the securitised exposures as if they had not been securitised. CRR, recognising the potential for diverging interpretations in respect of what constitutes implicit support, sets out in Article 248(2) a specific mandate for EBA to issue guidelines on what constitutes arm's length conditions and when a transaction is not structured to provide support. This consultation paper sets out the EBA proposal to fulfil this mandate.

These draft guidelines recognise the fact that implicit support should not cover support that institutions are already contractually obliged to provide. Such explicit support is assessed under guidelines EBA/GL/2014/05 on significant risk transfer. As such, the draft guidelines apply to transactions an institution is under no contractual obligation to enter into at all or is not under a contractual obligation to enter into on the specific terms of such transaction.

Pursuant to Article 248(1) CRR, a transaction shall not be considered to provide support if it is executed at arm's length conditions and taken into account in the assessment of significant risk transfer. Considering the fact that the provisions of CRR dealing with the recognition of significant risk transfer (Articles 243 and 244) apply to originator institutions but not to sponsor institutions, the draft guidelines propose that, in the case of sponsor institutions, a transaction is not structured to provide support if it is executed at arm's length conditions or on conditions which are more favourable to the sponsor institution than arm's length conditions. In the case of originator institutions, the guidelines apply the conditions set out in Article 248(1) CRR by interpreting the reference to the transaction being taken into account in the assessment of significant risk transfer as meaning that, following the relevant transaction, the conditions for significant risk transfer continue to be met.

Regarding the definition of arm's length conditions, the draft guidelines propose an objective test. In order to ensure that the test is applied correctly, the assessment is to be made having due regard to the information available to each of the parties at the time when the transaction is entered into, and not to such information as becomes available thereafter.

Furthermore, guidance is provided in respect of the application of the factors contemplated in points (a)-(e) of Article 248(1) CRR and the notification requirements applicable to such transactions.

## 3. Background and rationale

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1. Articles 243 and 244 CRR require any reduction of capital requirements achieved through securitisation to be justified by a commensurate transfer of risk to third parties.
  2. Support to a securitisation, whether the institution is required, pursuant to the terms of the securitisation, to provide such support (contractual support, i.e. credit enhancements provided at the inception of a securitised transaction) or whether the institution is not under an obligation to provide such support (implicit support) can take numerous forms. For instance, examples of contractual support include over collateralisation, credit derivatives, spread accounts, contractual recourse obligations, subordinated notes, credit risk mitigants provided to a specific tranche, the subordination of fee or interest income or the deferral of margin income. Examples of implicit support include the purchase of deteriorating credit risk exposures from the underlying pool, improving the quality of credit enhancements, such as through the addition of higher quality risk exposures, the sale of discounted credit risk exposures into the pool of securitised credit risk exposures, the purchase of underlying exposures at above market price, ad hoc credit enhancements provided to one or more tranches or an increase in the first loss position according to the deterioration of the underlying exposures.
  3. It is specifically the provision of implicit support which raises significant supervisory concerns. For both traditional and synthetic securitisation structures, the provision of implicit support undermines the achievement of significant risk transfer, therefore disallowing banks from excluding the securitised exposures from regulatory capital calculations. By providing implicit support, institutions signal to the market that all or part of the contractually transferred credit risk is still with the institution and has not in effect been transferred. The capital held by the institution can therefore understate the true risk.
  4. Accordingly, Article 248 CRR sets out restrictions on providing implicit support and provides that originator institutions and sponsor institutions having failed to comply with the relevant requirements shall at a minimum hold own funds against all of the securitised exposures as if they had not been securitised. Furthermore, pursuant to Article 98(3) of Directive 2013/36/EU, competent authorities are required to monitor whether an institution has provided implicit support to a securitisation and, if an institution is found to have provided implicit support on more than one occasion, the competent authority shall take appropriate measures reflective of the increased expectation that it will provide future support to its securitisation thus failing to achieve a significant transfer of risk.
  5. Thus, Article 248 CRR states that a transaction shall not be considered to provide support if it is executed at arm's length conditions and taken into account in the assessment of significant risk transfer. Furthermore, the institution shall, when assessing whether the transaction is not structured to provide support, adequately consider at least all of the following:
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- a. the price of the repurchase;
  - b. the institution's capital and liquidity position before and after repurchase;
  - c. the performance of the securitised exposures;
  - d. the performance of the securitisation positions; and
  - e. the impact of support on the losses expected to be incurred by the originator relative to investors.
6. Within this context, EBA is required to issue guidelines on what constitutes arm's length conditions and when a transaction is not structured to provide support.

## 4. Draft Guidelines

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EBA/GL/20XX/XX

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DD Month YYYY

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## Draft Guidelines

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on implicit support under Article 248(2)  
of Regulation (EU) No 575/2013

# 1. Compliance and reporting obligations

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## Status of these guidelines

1. This document contains guidelines issued pursuant to Article 16 of Regulation (EU) No 1093/2010<sup>1</sup>. In accordance with Article 16(3) of Regulation (EU) No 1093/2010, competent authorities and financial institutions must make every effort to comply with the guidelines.
2. Guidelines set the EBA view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. Competent authorities as defined in Article 4(2) of Regulation (EU) No 1093/2010 to whom guidelines apply should comply by incorporating them into their practices as appropriate (e.g. by amending their legal framework or their supervisory processes), including where guidelines are directed primarily at institutions.

## Reporting requirements

3. According to Article 16(3) of Regulation (EU) No 1093/2010, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines, or otherwise with reasons for non-compliance, by ([dd.mm.yyyy]). In the absence of any notification by this deadline, competent authorities will be considered by the EBA to be non-compliant. Notifications should be sent by submitting the form available on the EBA website to [compliance@eba.europa.eu](mailto:compliance@eba.europa.eu) with the reference 'EBA/GL/201x/xx'. Notifications should be submitted by persons with appropriate authority to report compliance on behalf of their competent authorities. Any change in the status of compliance must also be reported to EBA.
4. Notifications will be published on the EBA website, in line with Article 16(3).

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<sup>1</sup> Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC, (OJ L 331, 15.12.2010, p.12).

## 2. Subject matter, scope and definitions

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### Subject matter

5. These guidelines specify when a transaction is not structured to provide support and what constitutes arm's length conditions, according to Article 248 of Regulation (EU) No 575/2013<sup>2</sup>.

### Scope of application

6. These guidelines apply in relation to the restrictions on providing support to securitisations from sponsor institutions and originator institutions as referred to in Article 248 of Regulation (EU) No 575/2013 and in accordance with the conditions set out therein.

### Addressees

7. These guidelines are addressed to competent authorities as defined in point (i) of Article 4(2) of Regulation (EU) No 1093/2010 and to financial institutions as defined in Article 4(1) of Regulation (EU) No 1093/2010.

### Definitions

8. Unless otherwise specified, terms used and defined in Regulation (EU) No 575/2013 have the same meaning in these guidelines. In addition, for the purposes of these guidelines, 'transaction' means any transaction (for the avoidance of doubt, including, but not limited to, any amendments to the securitisation documentation and changes to the coupons, yields or other features of the securitisation positions) entered into by a sponsor institution or an originator institution in relation to a securitisation or positions therein after the closing of such securitisation which, pursuant to the terms of the securitisation documentation as in force prior to the entering into of such transaction, the originator institution or, as the case may be, the sponsor institution (i) is under no contractual obligation to enter into or (ii) is not under a contractual obligation to enter into on the specific terms of such transaction.

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<sup>2</sup> Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

## 3. Implementation

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### Date of application

9. These guidelines apply from dd.mm.yyyy.

## 4. Implicit support

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### Transaction not structured to provide support

10. For the purposes of Article 248 of Regulation (EU) No 575/2013, originator institutions, sponsor institutions and competent authorities should determine that a transaction is not structured to provide support if it satisfies the following conditions:
  - a. in the case of a transaction carried out by a sponsor institution, the transaction is executed (i) at arm's length conditions or (ii) on conditions which are more favourable to the sponsor institution than arm's length conditions;
  - b. in the case of a transaction carried out by an originator institution which has transferred significant credit risk associated with the underlying exposures of the securitisation in accordance with Article 243 or 244 of Regulation (EU) No 575/2013:
    - i. the transaction is executed (1) at arm's length conditions or (2) on conditions which are more favourable to the originator institution than arm's length conditions; and
    - ii. the securitisation continues to meet the conditions for significant risk transfer as set out in Article 243 or, as the case may be, 244 of Regulation (EU) No 575/2013 and in accordance with these guidelines and with guidelines EBA/GL/2014/05 on significant risk transfer.

### Notification and documentation

11. Where a transaction which would be subject to these guidelines had it been entered into by the originator institution is entered into by an entity (other than the originator institution) which is connected to the originator institution in a manner that might undermine the credit risk transfer, the originator institution should notify such transaction to the competent authority and the competent authority should assess the transaction as if it had been entered into by the originator institution. Competent authorities and originator institutions should consider any relevant connection between the third parties or the sponsor institution and the

originator institution, including whether the originator institution provides the third parties or the sponsor institution with financing or with any support or instructions for the purposes of undertaking the relevant transaction.

12. When notifying a transaction as required pursuant to Article 248 of Regulation (EU) No 575/2013 or pursuant to paragraph 11, the originator institution or, as the case may be, the sponsor institution should:
- a. when it claims that the transaction does not constitute implicit support, provide adequate evidence to the effect that the relevant conditions set out in paragraph 10 of these guidelines are met; and
  - b. if the transaction is undertaken by the sponsor institution or by another entity (other than the originator institution):
    - i. with which the originator institution has an existing relationship;
    - ii. to which the originator institution provided any support or instruction in relation to the transaction being notified pursuant to this paragraph 12; or
    - iii. with which the originator institution entered into any transaction in relation to the transaction being notified pursuant to this paragraph 12,

the originator institution or, as the case may be, the sponsor institution should include in the evidence provided pursuant to point a. above the type of relationship between the originator institution and the sponsor institution or the third party entity or, as the case may be, the support, instructions or transactions provided by or undertaken by the originator institution in relation to the sponsor institution or the third party entity for the purposes of undertaking the relevant transaction.

## Arm's length conditions

13. For the purposes of Article 248 of Regulation (EU) No 575/2013, originator institutions, sponsor institutions and competent authorities should consider that a transaction is executed at arm's length conditions if the terms of the transaction are such as they would be in a normal commercial transaction if the parties had no relationship to each other (including, but not limited to, any special duty or obligation and any possibility to control or influence each other) and each party acted independently, entered into the transaction of its own volition, acted in its own interests and did not take into account any extraneous considerations which are not directly connected with the transaction in question (including, but not limited to, any reputational risk which might arise in respect of the originator institution or the sponsor institution should it not proceed with the transaction).
14. In carrying out such assessment, originator institutions, sponsor institutions and competent authorities should have due regard to the information available to each of the parties at the

time when the transaction is entered into, and not to such information as becomes available thereafter.

## Significant risk transfer

15. In evaluating a transaction in accordance with Article 248 of Regulation (EU) No 575/2013, competent authorities should assess whether the conditions for significant risk transfer as set out in Article 243 or, as the case may be, Article 244 of that Regulation continue to be met, in accordance with these guidelines and with guidelines EBA/GL/2014/05 on significant risk transfer.
16. A transaction should, among other things, be deemed to invalidate the conditions for significant risk transfer if:
  - a. the credit risk of the originator institution after undertaking the transaction materially increases; or
  - b. the capital or liquidity position of the originator institution is, directly or indirectly, materially affected by the transaction

where, as a result of the transaction, the reduction in risk-weighted exposure amounts the originator institution initially achieved is no longer justified by a commensurate transfer of credit risk to third parties.

17. In assessing whether the credit risk is materially increased following the undertaking of a transaction, in accordance with paragraph 16 of these guidelines, all relevant factors should be considered, including, but not limited to, material changes in the market price of the securitisation positions, material changes in the total risk weighted exposure amounts of the securitisation position holders and changes in the securitisation position ratings. Any assets that the originator institution transfers back to its balance sheet as a result of the transaction should be included in the originator institution's assessment of the changes in the total risk weighted exposure amounts.
18. In accordance with Article 98(3) of Directive 2013/36/EU<sup>3</sup>, 'competent authorities shall monitor whether an institution has provided implicit support to a securitisation. If an institution is found to have provided implicit support on more than one occasion the competent authority shall take appropriate measures reflective of the increased expectation that it will provide future support to its securitisation thus failing to achieve a significant transfer of risk'.

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<sup>3</sup> Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

## Relevant factors for assessment

19. When assessing whether a transaction is not structured to provide support as set out in paragraph 10 of these guidelines, originator institutions, sponsor institutions and competent authorities should consider all relevant circumstances, including the following criteria.
20. In respect of the factor contemplated in point (a) of Article 248(1) of Regulation (EU) No 575/2013 (the price of the repurchase), originator institutions, sponsor institutions and competent authorities should, in the case of transactions other than a repurchase, consider the amounts payable or, as the case may be, receivable by the originator institution or, as the case may be, the sponsor institution. Originator institutions and sponsor institutions should consider measures of market value, including quoted prices in active markets for identical transactions that the institution can access at the measurement date. If such measures are not identifiable, then originator institutions and sponsor institutions should consider inputs other than quoted prices that are directly or indirectly observable for the asset; and, if such inputs are not identifiable, then unobservable inputs for the asset should be considered. In the case of unobservable inputs, the originator institution or sponsor institution should provide evidence to its competent authority regarding how the receivable or payable amounts have been valued and which inputs were used. The originator institution or sponsor institution should also demonstrate that this assessment is in line with its credit review and approval process. Competent authorities should consider that a transaction is not executed at arm's length conditions if the amounts receivable by the originator institution or, as the case may be, the sponsor institution are materially lower than, or the amounts payable by the originator institution or sponsor institution are materially higher than, the relevant market value.
21. Originator institutions, sponsor institutions and competent authorities should consider the factor contemplated in point (b) of Article 248(1) of Regulation (EU) No 575/2013 (the institution's capital and liquidity position before and after repurchase) as also being relevant in the case of transactions other than a repurchase. Competent authorities should consider that the conditions for significant risk transfer are no longer satisfied if the originator institution's capital or liquidity position is materially affected, directly or indirectly, by the transaction and, as a result of the transaction, the reduction in risk-weighted exposure amounts the originator institution initially achieved is no longer justified by a commensurate transfer of credit risk to third parties. In making such assessment, competent authorities should consider, among other things, the accounting entries that the participants to the transaction made with respect to the transaction and the changes in their liquidity position, respectively.
22. Regarding the factor contemplated in point (c) of Article 248(1) of Regulation (EU) No 575/2013 (the performance of the securitised exposures), originator institutions, sponsor institutions and competent authorities should consider, in case the underlying exposures being subject to the transaction have been underperforming relative to other securitised exposures or have been reported as non-performing, that the transaction is not executed at

arm's length conditions if either such underperformance or the foreseeable future performance of such exposures as a result of the circumstances having caused such underperformance is not adequately reflected in the price of the purchase or repurchase.

23. Regarding the factor contemplated in point (d) of Article 248(1) of Regulation (EU) No 575/2013 (the performance of the securitisation positions), originator institutions, sponsor institutions and competent authorities should consider, in case the securitisation positions being subject to the transaction have been underperforming relative to other securitisation positions or have been reported as non-performing, (i) whether the cost of measures taken to improve the performance of these securitisation positions has been fully borne by the relevant securitisation investors and (ii) whether the institution which participated in the transaction is negatively affected, directly or indirectly, by the transaction.
24. Regarding the factor contemplated in point (e) of Article 248(1) of Regulation (EU) No 575/2013 (the impact of support on the losses expected to be incurred by the originator relative to investors), originator institutions, sponsor institutions and competent authorities should consider whether the expected losses of a securitisation position are materially increased or reduced, having regard, among other things, to changes in the market price of the position, in the risk-weighted exposure amounts and in the ratings of securitisation positions.

## 5. Accompanying documents

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### 5.1 Draft cost-benefit analysis / impact assessment

#### Introduction

Article 16(1) of the EBA Regulation (Regulation (EU) No 1093/2010 of the European Parliament and of the Council) provides that any guidelines developed by the EBA shall be accompanied by an analysis of ‘the potential related costs and benefits’. This analysis should provide an overview of the findings regarding the problem to be dealt with, the solutions proposed and the potential impact of these options.

#### Scope and nature of the problem

Securitisations can help institutions to efficiently manage their balance sheet and diversify their funding sources. Securitisations are also a recognised credit risk mitigation tool, which can significantly reduce credit risk by transferring it to a third party. CRR requires that any reduction of capital requirements achieved through securitisation be justified by a commensurate transfer of risk to third parties. Considering this, the provision of implicit support to the securitisation raises significant supervisory concerns and restrictions are therefore placed in Article 248 CRR on providing support to the securitisation beyond existing contractual obligation. It is therefore important to assess when a transaction is structured to provide support.

#### *Objectives of the guidelines*

In Article 248(2) CRR, the EBA is mandated to issue guidelines on what constitutes arm’s length conditions and when a transaction is not structured to provide support. This is necessary in order to ensure that the prohibition in Article 248 CRR is applied consistently. The arm’s length test constitutes part of the assessment of whether the transaction is structured to provide support.

The proposed guidelines seek to address the mandate by defining the notions outlined above and by providing further guidance on how the factors contemplated in points (a)-(e) of Article 248(1) CRR should be assessed.

## Technical options considered

This section explains the rationale behind some of the choices that the EBA has made when designing the guidelines. The main principle followed was that a workable test should be provided, which would ensure a consistent application of the prohibition on providing implicit support without affecting legitimate transactions.

The guidelines include (i) the conditions to be satisfied in order to determine that a relevant transaction is not structured to provide support, depending on whether the relevant transaction is entered into by a sponsor institution or by an originator institution, (ii) an objective test for assessing whether a relevant transaction is entered into at arm's length terms, (iii) clarifications regarding the notification requirements for relevant transactions and (iv) further guidance on how the conditions for assessing whether a transaction is structured to provide support, including the factors set out in points (a)-(e) of Article 248(1) CRR, should be assessed. The scope of the guidelines goes partly beyond the mandate in CRR where this is considered necessary by the EBA.

### *Requirements for originator institutions and sponsor institutions*

The guidelines set out details of the assessments that originator institutions and sponsor institutions will need to undertake and the information they should provide to competent authorities when contemplating entering into a relevant transaction.

### *Requirements for competent authorities*

The guidelines establish the test to be applied by competent authorities when assessing whether a relevant transaction constitutes implicit support and provide further guidance on how the test should be applied.

## Costs

EBA believes that there will be two types of costs:

**Costs for competent authorities** – The main direct cost for competent authorities will be in relation to the processes for assessing whether a relevant transaction constitutes implicit support. The guidelines could generate additional compliance costs within those Member States which currently conduct less extensive checks than those proposed by the guidelines. Such costs for the competent authorities could be driven for instance by the need to change some of their existing processes, to train existing staff or hire additional staff members.

**Costs for relevant institutions** – The main cost for relevant institutions will be related to setting up processes in order to be able to disclose the necessary information and evidence to the competent authorities and to ensure that each relevant transaction is properly assessed. The compliance costs of these guidelines are likely to vary between jurisdictions.

## **Benefits**

By specifying the test to be applied by competent authorities and relevant institutions in assessing whether a transaction is structured to provide support and providing guidance on how it should be applied, the guidelines ensure that a more consistent approach will be taken to the application of the implicit support regime.

## 5.2 Overview of questions for consultation

Question 1: Do you have any general comments on the draft guidelines on implicit support under Article 248(2) of Regulation (EU) No 575/2013?

Question 2: Do you have any comments on the proposed definition of transactions not structured to provide support?

Question 3: Do you have any comments on the proposed definition of arm's length conditions?

Question 4: Do you have any comments on the proposed guidance regarding the factors contemplated in points (a)-(e) of Article 248(1) of Regulation (EU) No 575/2013?

Question 5: Is the arm's length condition in paragraph 10.a of the draft guidelines sufficient to test in all cases whether a sponsor provides support? If not, what would be an appropriate requirement? Please provide examples.

Question 6: Should transactions undertaken by a third party other than the sponsor institution or originator institution be subject to the same assessment with regard to the provision of implicit support as transactions undertaken by the sponsor institution or by the originator institution or should they be subject to different assessment standards (and, if so, which standards)?