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19 September 2017

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# Discussion Paper

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On the Significant Risk Transfer in Securitisation

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# Contents

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<b>1.</b>	<b>Regulatory treatment of SRT and EBA mandate</b>	<b>11</b>
1.1	Objectives and drivers of the significant risk transfer	11
1.2	Regulatory treatment of SRT	12
1.2.1	Own funds requirements Regulation (CRR)	13
1.2.2	EBA Guidelines and reporting to EBA on SRT	17
1.3	Changes to the regulatory treatment of SRT in the new EU securitisation framework	18
1.4	EBA mandate on SRT	19
<b>2.</b>	<b>Overview of market and supervisory practices with respect to SRT</b>	<b>21</b>
2.1	Overview of market practices in relation to SRT	21
2.2	Overview of supervisory frameworks for assessment of SRT	26
<b>3.</b>	<b>Assessment of SRT and EBA proposals for discussion</b>	<b>28</b>
3.1	Assessment and proposals for discussion in relation to the SRT process	30
3.1.1	Supervisory and market approaches to the process of SRT assessment	30
3.1.2	EBA proposals for discussion on the SRT process	33
3.2	Assessment and proposals for discussion with respect to selected structural features of SRT transactions	35
3.2.1	Assessment of selected structural features of SRT transactions	35
3.2.2	Amortisation structure	37
3.2.3	Call options	41
3.2.4	Excess spread	44
3.2.5	Cost of protection	52
3.2.6	Other early termination clauses	55
3.2.7	Credit events (synthetic securitisation only)	57
3.2.8	Credit protection payments and loss calculation	58
3.2.9	Replenishment and substitution of assets	59
3.2.10	Originator's quantitative self-assessment of risk transfer: stress-test analysis on risk transfer accompanying the SRT application	60
3.3	Assessment and suggested options with respect to quantitative SRT tests	64
3.3.1	Assessment of the quantitative SRT tests	64
3.3.2	Options suggested by EBA	70
3.3.3	EBA proposals for discussion for enhancing the quantitative tests	79
<b>4.</b>	<b>The regulatory treatment of NPL securitisation</b>	<b>82</b>
4.1	NPL securitisation: market activity	83
4.2	The market practice of NPL transfer	85
4.2.1	Transfer model	85
4.2.2	The core elements of the NPL securitisation process	86
4.2.3	NPL securitisation and public guarantees	90
4.3	The regulatory treatment of NPL securitisation applicable to the originator	92

4.3.1	The definition of NPL	92
4.3.2	The accounting treatment of NPL securitisation	94
4.4	Pre- and post-securitisation own funds requirements in NPL securitisation	96
4.4.1	Further considerations for stakeholders' consultation	103
	<b>Summary of the questions for stakeholders</b>	<b>105</b>
	<b>Annexes</b>	<b>109</b>
	Annex 1: Analysis of supervisory frameworks used for the SRT assessment	109
	Annex 2: Analysis of specific market practices in relation to SRT	138
	Annex 3: Additional data on the SRT transactions	143
	Annex 4: Case studies of SRT transactions tested under the quantitative tests proposed by the EBA	146

# 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 stated in the boxes below (and summarised at the end of this paper).

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 view expressed;
- describe any alternatives the EBA should consider; and
- provide where possible data for a cost and benefit analysis.

## Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by **19 December 2017**. 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.

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## Disclaimer

The views expressed in this discussion paper are preliminary and will not bind in any way the EBA in the future development of the draft advice. They are aimed at eliciting discussion and gathering the stakeholders' opinion at an early stage of the process.

## List of acronyms

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CA	Competent authority
ECAI	External Credit Assessment Institutions
EL	Expected loss
IRB	Internal Ratings Based approach for calculation of own funds requirements under the credit risk framework
NPLs	Non-Performing Loans
RWEA	Risk Weighted Exposure Amounts
SA	Standardised Approach for calculation of own funds requirements under the credit risk framework
SEC-ERBA	Securitisation External Ratings-Based Approach
SEC-IRBA	Securitisation Internal Ratings-Based Approach
SEC-SA	Securitisation Standardised Approach
SSPE	Securitisation Special Purpose Entity
STS	Simple, Transparent and Standardised Securitisation
SRT	Significant Risk Transfer
UL	Unexpected loss
WAL	Weighted Average Life

## List of figures

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Figure 1: Additional conditions and requirements on the recognition of SRT .....	15
Figure 2: Options for the originator in the securitisation framework to exclude the securitised exposures from the calculation of risk-weighted exposure amounts .....	16
Figure 3: SRT transactions requiring notification in accordance with the EBA Guidelines: number of transactions and jurisdictions .....	22
Figure 4: Traditional vs synthetic securitisation: number of SRT transactions and notional value .	22
Figure 5: Number of SRT transactions (traditional vs synthetic securitisations) .....	22
Figure 6: Number of SRT transactions per size bucket (m EUR) .....	23
Figure 7: Type of collateral and notional value of the SRT transactions.....	23
Figure 8: Type of collateral, as % of notional value, for total number of reported transactions ....	24
Figure 9: Originator's call options included in the SRT transactions.....	24
Figure 10: Originator's call options included vs not included .....	24
Figure 11: Risk retention: number and percentage of transactions per each type of risk retention (for 26 out of 49 transactions) .....	25
Figure 12: Overview of supervisory frameworks on SRT .....	27
Figure 13: Different types of amortisation structure.....	38
Figure 14: The impact of synthetic excess spread (SES) on a transaction's structure .....	47
Figure 15: Rationale of the mezzanine SRT test (test pursuant to point (a) of CRR 243(2) and 244(2)).....	65
Figure 16: Rationale of the first loss SRT test (text pursuant to point (b) of CRR 243(2) and 244(2)) .....	66
Figure 17: Options proposed by EBA with respect to the quantitative SRT tests.....	72
Figure 18: Issuance of NPL and re-performing securitisation transactions as per available data ..	85
Figure 19: Different forms of portfolio divestment/transfer .....	86
Figure 20: The costs of NPL resolution: investor perspective (illustrative example – sources Arrow Global and EBA calculations).....	88
Figure 21: Summary of differences among existing definitions of asset quality .....	93
Figure 22: Impairment requirements under IFRS 9 (sources: Deloitte).....	96
Figure 23: Own funds requirements on NPL exposures.....	97
Figure 24: An example of NPL securitisation transaction .....	99

Figure 25: SEC-IRBA and SEC-SA risk weights on the stylised NPL transaction: GBV approach to tranche capital (see Box 5 for the underlying assumptions) ..... 102

Figure 26: Overview of supervisory practices with respect to the process of the SRT assessment ..... 110

Figure 27: EU regulatory framework for call options in securitisation transactions ..... 118

Figure 28: Transactions assessed in the case studies ..... 146

## Executive Summary

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1. Achieving regulatory significant risk transfer (SRT), and the associated regulatory capital relief, represents one of the primary considerations for originator institutions when structuring securitisation transactions. SRT is granted by competent authorities on the basis of a transaction-by-transaction assessment, and is governed by the CRR provisions of the securitisation framework, the EBA Guidelines on SRT from 2014 (hereafter ‘the EBA Guidelines’) and, where available, more detailed national supervisory SRT frameworks.
2. Given the significance of the SRT considerations in structuring securitisation transactions, enhancing level playing field and regulatory and supervisory certainty in the single market is a crucial element in efforts aimed at reviving the securitisation market - one of the main pillars of the Commission’s Capital Markets Union plan. The establishment of the new framework for simple, transparent and standardised securitisation will highlight this importance of SRT even further, given that the achievement of SRT will allow originator institutions to exclude the securitised exposures from the calculation of the risk weighted exposure amounts and apply STS beneficial risk weights to the retained securitisation positions. In order to achieve a harmonised treatment of securitisation transactions in the EU, the supervisory assessment of SRT is therefore of crucial importance.
3. The EBA reviewed the overall SRT framework and found that supervisory approaches with respect to SRT are heterogeneous across Member States in a number of areas, including the process of SRT assessment and the policy approach towards selected structural features of SRT transactions. Divergent SRT assessments and outcomes also partly reflect limitations and lack of detailed regulatory treatment within existing EU provisions on SRT, including but not limited to the quantitative tests of the CRR to measure SRT. Overall, this means that transactions with comparable characteristics may currently be assessed differently across Member States, leading to potentially unjustified differences in SRT outcomes and risk-weighted exposure amounts calculations.
4. As a result of an in-depth analysis undertaken, the EBA seeks market participants’ views on enhancing the regulatory and supervisory level playing field with respect to the assessment and recognition of SRT, in three core areas.
  - Firstly, the standardisation of the process of SRT assessment by competent authorities, as regards the originators’ notification of SRT and the competent authority’s feedback on the achievement of SRT, for any particular transaction.
  - Secondly, a set of selected structural features that are widely present in securitisation transactions and that affect the sustainability of SRT during the life of the transaction, including but not limited to the use of excess spread and pro-rata amortisation schemes. The EBA seeks views on the proposals to strengthen the level playing field in



the supervisory assessment of such features, in two regards. Firstly, a set of safeguards in relation to each structural feature, the presence of which in the transaction should facilitate the comprehensive assessment of the transaction by the competent authority, and all else being equal increase likelihood of SRT being granted. Secondly, a risk transfer self-assessment that originators should submit to the competent authority, to accompany their SRT notification, whenever the securitisation transaction features any of such structural features. An additional 'stress test' exercise should in particular test how the regulatory capital relief achieved by the originator and the losses absorbed by third party investors compare to total losses arising over the lifetime of the transaction.

- Finally, a set of proposals that are aimed to tackle the identified limitations of the EU framework to measure SRT, and in particular to provide a platform for a more harmonised assessment of the concept of commensurate risk transfer. A first option (option 1) could be to enhance the existing tests by: (i) introducing a new requirement on the minimum thickness of the first loss tranche, and (ii) introducing a test of commensurate risk transfer, based on a comparison of the capital relief achieved by the originator with the portion of total portfolio losses that is transferred to investors. Stakeholders' feedback is also sought on an alternative proposal (option 2) to supplement the existing CRR tests, or to potentially replace them, with a comprehensive new test which, on a one-year regulatory time horizon, tests both significant risk transfer and commensurate risk transfer.
5. In addition, the Discussion Paper provides an overview of the current market practices of transfer of non-performing loans (NPLs), including a description of the public support initiatives introduced so far to facilitate NPL securitisation. Most importantly, it elaborates on the regulatory treatment of NPL securitisations, focusing on the calculation of pre- and post-securitisation own funds requirements that represent a crucial element of the SRT assessment. In light of several specificities that characterise securitisation transactions structured on defaulted exposures, the discussion paper seeks stakeholders' views on the regulatory treatment of NPL securitisation, on the basis of the new EU securitisation framework, with a two-fold objective: (i) first, to assess for NPL transactions the workability of the SRT framework proposed for securitisations of performing exposures; (ii) second, to understand whether any element of the new regulatory framework applicable to NPL securitisation transactions may pose unintended hurdles to the well-functioning of the market for NPL securitisations, which represents one of the viable routes to take forward the European policy agenda on the resolution of NPLs.
6. To respond to the dynamics of the regulatory developments, the initial proposals presented in this paper have been designed to be compatible with both the existing as well as the new EU securitisation framework, including the preferential treatment for STS securitisation entering into force at the beginning of 2018. Also, taking into account that the EBA proposals principally address the aspects of SRT which are currently not explicitly regulated at EU level or the regulatory treatment of which is of high level or non-binding nature (such

as aspects treated in the EBA Guidelines), they should be considered as an addition to, rather than a replacement of, the applicable regulatory SRT framework.

7. This Discussion Paper was developed in response to a CRR mandate to the EBA to monitor the range of supervisory practices in relation to SRT. The CRR as amended within the new EU securitisation framework extends that mandate to specifically review some particular issues, such as the conditions determining SRT, the concept of commensurate risk transfer, as well as the requirements for competent authorities when assessing SRT.
8. The objective of the Discussion Paper is to gather stakeholders' views on the proposed approaches to enhancing the regulatory and supervisory treatment of SRT, in the above mentioned areas. The feedback should serve as an input to the final EBA technical advice to the Commission, and finally to a Delegated Act that the Commission may develop in the future taking account of the EBA advice. The EBA will continue to pursue its important role and to monitor the range of supervisory and market practices in relation to the recognition of SRT, going forward.

# 1. Regulatory treatment of SRT and EBA mandate

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*This chapter provides an introduction to the concept of the significant risk transfer (SRT) in securitisation. It describes its regulatory treatment in the context of the existing and the new EU securitisation framework. It then introduces the EBA mandate on SRT as envisaged in the current and amended CRR as well as the structure of the EBA analysis undertaken in this Discussion Paper in response to the regulatory mandate.*

## 1.1 Objectives and drivers of the significant risk transfer

9. The CRR<sup>1</sup> allows the originator of a securitisation transaction to exclude the securitised exposures from the calculation of its risk-weighted exposure amounts, while risk weighting any retained position in the securitisation transaction, provided that the capital relief is justified by a significant transfer of risk (SRT) associated with the securitised exposures to third parties, i.e. provided that the transaction achieves regulatory SRT.
10. The actual extent of capital relief depends on many factors, including the amount of securitisation positions the originator decides to retain, the asset class of the underlying exposures and the specific capital structure of the securitisation transaction, and is in any case mitigated by the principle of non-neutrality of securitisation capital embedded in the Basel and CRR securitisation frameworks<sup>2</sup>.
11. For the SRT to be achieved, it is not necessary to transfer the entire risk of the portfolio. However, the overarching principle for the concept of SRT is that any reduction in own funds requirements must be matched by a transfer of risk that is significant and commensurate. The main focus of the supervisory assessments by the competent authorities is therefore to ensure that significant and commensurate risk transfer effectively occurs, so as to justify the capital relief achieved by the originator, not only according to the conditions set out in legislation, but also as regards the economic substance of each specific transaction. A capital relief not justified by an effective risk transfer would result in a weakening of the capital position of the institution.

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<sup>1</sup> Part Three, Title II, Chapter 5 of the current CRR, Art. 242 - 270 CRR.

<sup>2</sup> Non-neutrality is a principle according to which the own funds requirements applicable to all tranches of a given securitisation transaction are higher than those that would apply to the underlying portfolio of exposures had this portfolio not been securitised.

12. While the CRR allows achieving SRT for both traditional and synthetic transactions, market analysis confirms that the majority of current transactions that achieved SRT have been synthetic transactions (see Section 2.1 for further information on the overview of market practices on SRT). The regulatory capital relief is indeed one of the main objectives for structuring a synthetic securitisation transaction, next to credit risk and balance sheet management. Traditional securitisations are primarily undertaken for funding purposes under the current market circumstances, rather than primarily for achieving risk transfer.
13. Depending on the final outcome of Basel III/CRR II negotiations, it is expected however that more traditional securitisation transactions will be undertaken also for the purposes of risk transfer.<sup>3</sup> The proposal currently under negotiations not only allows SRT to determine the exclusion of the securitised exposures from the risk weighted exposure amounts, but also from the leverage ratio measure of regulatory capital. According to this proposal, only the retained tranches in the securitisation should continue to be included in the leverage ratio exposure measure.

## 1.2 Regulatory treatment of SRT

14. The regulatory framework for the SRT is framed by the CRR<sup>4</sup> (Art. 243 and 244)<sup>5</sup> and the EBA Guidelines on SRT, the latter applicable since July 2014.<sup>6</sup>
15. In 5 jurisdictions (DE, LU, IT, SSM, UK)<sup>7</sup> supplementary supervisory frameworks for SRT assessment have been developed, to apply and supplement the EBA Guidelines. In some jurisdictions, additional guidance on SRT has been published, such as the guidance on procedures to be followed by significant supervised institutions as regards the recognition of SRT published by ECB in March 2016,<sup>8</sup> and a supervisory statement related to the SRT published by UK PRA in December 2013.<sup>9</sup>

<sup>3</sup> BCBS consultative document on the revisions to the Basel III leverage ratio framework: <https://www.bis.org/bcbs/publ/d365.pdf> ; Commission's proposal for CRR II (November 2016): <https://ec.europa.eu/transparency/regdoc/rep/1/2016/EN/COM-2016-850-F1-EN-MAIN.PDF>

<sup>4</sup> The concept of SRT is one of core elements of the securitisation framework of the CRR (covered in Part Three, Title II, Chapter 5, Art. 242 – 270 CRR).

<sup>5</sup> Recognition of SRT: Art. 243 applies to traditional securitisation, and Art. 244 applies to synthetic securitisation.

<sup>6</sup> EBA Guidelines on SRT: <https://www.eba.europa.eu/regulation-and-policy/securitisation-and-covered-bonds/draft-guidelines-on-significant-risk-transfer-srt-for-securitisation-transactions>

<sup>7</sup> Including these 5 jurisdictions in total 23 jurisdictions responded to the EBA questionnaire on SRT in 2016.

<sup>8</sup> ECB public guidance on the recognition of SRT:

[https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance\\_significant\\_risk\\_transfer.en.pdf](https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_significant_risk_transfer.en.pdf)

<sup>9</sup> UK PRA supervisory statements related to the SRT:

<http://www.bankofengland.co.uk/pras/Documents/publications/ss/2013/ss913.pdf>

### 1.2.1 Own funds requirements Regulation (CRR)

16. The CRR (Art. 243 and 244) allows an originator of a securitisation transaction to exclude the securitised exposures from the calculation of risk-weighted exposure amounts<sup>10</sup>, if either of the following conditions is met:
- a. Significant credit risk associated with the securitised exposures is considered to have been transferred to third parties i.e. **significant risk transfer (SRT) is being achieved** (Art. 243(1)(a) and 244(1)(a)). The originator may choose one of three options available in the CRR to demonstrate that SRT has been achieved (see the section below);
  - b. The originator applies a 1 250 % risk weight to all retained positions in the securitisation or deducts these securitisation positions from CET1 items i.e. it applies the **full deduction option** as later referred to in the document (Art. 243(1)(b) and 244(1)(b)).
17. Irrespective of whether the originator intends to meet the condition (a) or (b) as referred to in the previous paragraph, the securitisation transaction it originates must comply with all the requirements specified in Art. 243(5) or 244(5) CRR, as applicable, including the requirements on an effective transfer of credit risk to third parties.

#### Achievement of the Significant Risk Transfer

18. The CRR provides for three possible ways for securitisation transactions to achieve significant risk transfer to third parties:
- a. Compliance with one of two available **quantitative tests**;
  - b. A **permission from the competent authority** to consider that significant risk transfer is achieved, irrespective of whether or not the transaction meets the quantitative tests.
19. The quantitative tests use a quantitative formula so as to assess whether a significant part of the credit risk associated with the securitised exposures is transferred to third parties. The CRR provides for two quantitative tests:
- a. **'Mezzanine test'** applicable to transactions with mezzanine securitisation positions (Art. 243(2)(a), Art. 244(2)(a)), which requires the originator to transfer

<sup>10</sup> The CRR allows the originator to either (i) exclude the securitised exposures from the calculation of risk-weighted exposure amounts and, where relevant, expected loss amounts (in case of traditional securitisation), or (ii) to calculate risk-weighted exposure amounts and, where relevant, expected loss amounts for the securitised exposures in accordance with Article 249 and 250 CRR (in case of synthetic securitisation).

to third parties at least 50% of the risk weighted exposure amounts (RWEA) resulting from mezzanine positions<sup>11</sup>;

- b. **'First loss test'** applicable to transactions with no mezzanine positions (Art. 243(2)(b), Art. 244(2)(b)), which prescribes that the originator can retain a maximum of 20% of the exposure value of the positions subject to CET1 deduction/1250% risk weight, i.e. it requires that at least 80% of the exposure value of such positions is transferred to third parties. It also requires the respective tranche to be sufficiently thick to exceed a reasoned estimate of the expected loss on the securitised exposures by a 'substantial margin'.
20. The quantitative tests set a benchmark to assess the significance of risk transfer. Passing the quantitative tests, however, is not a sufficient condition to achieve SRT: the CRR gives discretion to the competent authorities to decide on a case-by-case basis that the RWEA reduction cannot be applied, when the competent authority considers that the capital reduction is not justified by a commensurate transfer of credit risk to third parties (Art. 243(2) 2nd subparagraph, Art. 244(2) 2nd subparagraph).
  21. As an alternative to the quantitative tests described above, originators may request the permission of the competent authority to consider the SRT to have been achieved. According to the CRR, the originator needs to comply with the following conditions for such permission to be granted: (i) it is able to demonstrate that the transfer of credit risk to third parties is commensurate with the RWEA reduction; (ii) it has appropriately risk-sensitive policies and methodologies in place to assess the transfer of risk; and (iii) it has recognised the transfer of credit risk in its internal risk management and capital allocation. The permission and its scope are subject to decision of each competent authority.
  22. Based on the data reported to EBA in the SRT notifications for SRT transactions conducted since July 2014, a substantial majority of the reported SRT transactions have been assessed under one of the quantitative tests, and the application of the permission-based SRT has been very limited in practice.
  23. The CRR requires competent authorities to keep the EBA informed about the specific cases where the RWEA reduction is not justified by a commensurate transfer of credit risk (in case of application of quantitative SRT tests), and the use by originators of the permission-based SRT (Art. 243(6) and 244(6)).
  24. The CRR sets out additional conditions and requirements for the recognition of SRT, which aim to ensure the effectiveness of the risk transfer and to prevent that the originator takes

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<sup>11</sup> For the purpose of this test, mezzanine positions means all securitisation positions which have risk weights lower than 1250% and which are more junior than the most senior position in the securitisation and at the same time more junior than any securitisation position assigned CQS1 when SA is used, or CQS 1 or 2 when IRB is used (Art. 243(3) and 244(3)).

the transferred risk back on its balance sheet (Art. 243(5), Art. 244(5)). An overview of these requirements for both traditional and synthetic transactions is provided in Figure 1.

**Figure 1: Additional conditions and requirements on the recognition of SRT**

**Traditional securitisation (Art. 243(5) CRR):**

- the securitisation documentation reflects the economic substance of the transaction;
- the securitised exposures are put beyond the reach of the originator and its creditors, including in insolvency and receivership. Legal opinions from qualified legal counsel are required in this regard ;
- the securities issued do not represent payment obligations of the originator (i.e. the transferee is a special purpose vehicle);
- the originator does not retain effective or indirect control over the transferred exposures. This restriction against control includes the right to repurchase from the transferee the previously transferred exposures in order to realise their benefits, and the obligation to reassume transferred risk. This does not prevent the originator from retaining the servicing rights;
- any purchase or repurchase of securitisation positions by the originator or sponsor beyond its contractual obligations is exceptional and may only be made at arm's length conditions;
- the securitisation documentation does not include provisions that require positions in the securitisation to be improved by the originator (other than in the case of early amortisation provisions), including provisions which alter the underlying credit exposures or increase the yield payable to holders of positions in the securitisation in response to a deterioration in the credit quality of the underlying pool.
- any clean-up call is exercisable at the option of the originator only when 10% or less of the value of the securitised exposures remains unamortised, and such call is not structured to provide credit enhancement.

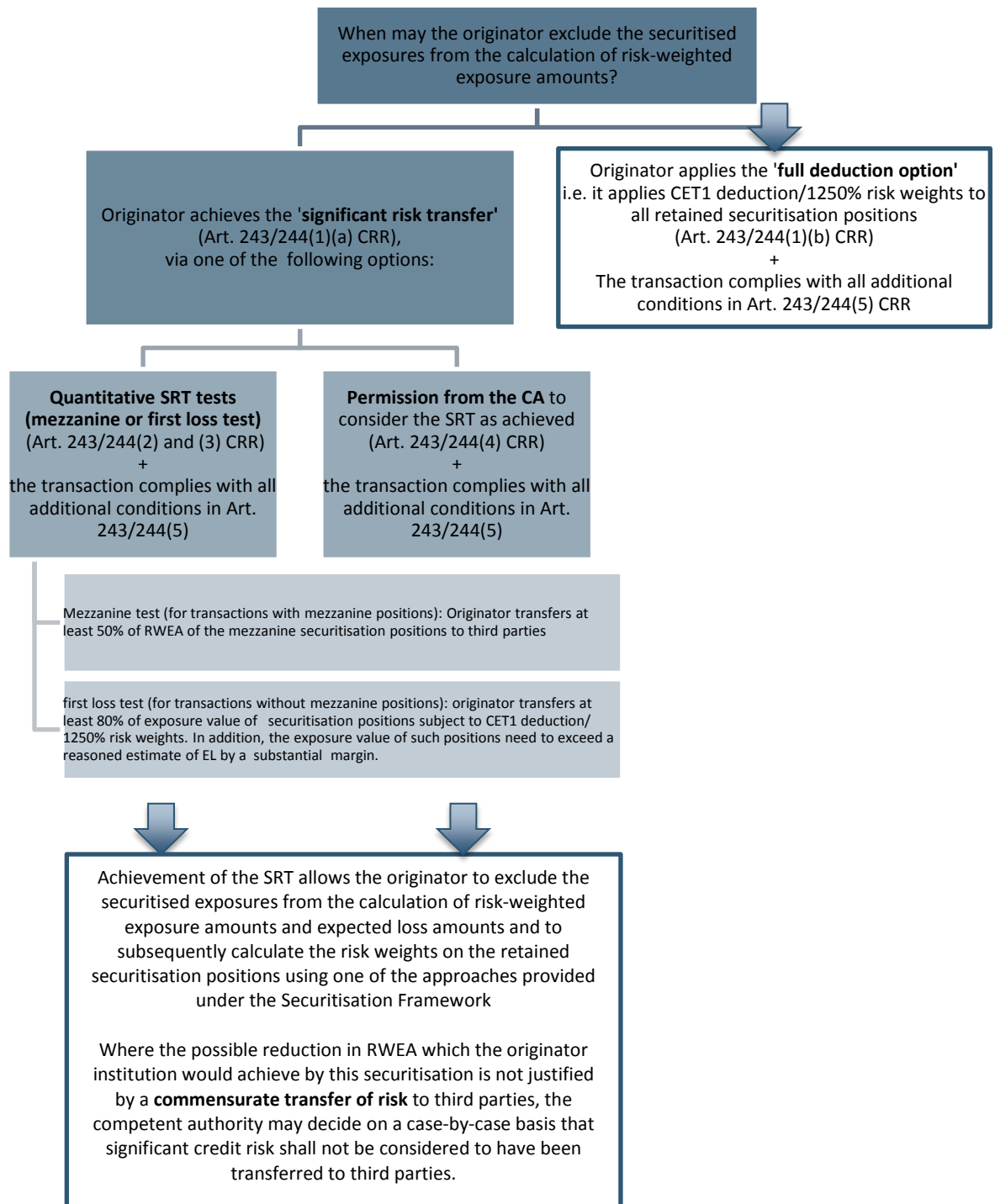
**Synthetic securitisation (Art. 244(5) CRR):**

- the securitisation documentation reflects the economic substance of the transaction;
- the credit risk is transferred via credit protection which complies with certain eligibility and other requirements for credit risk mitigation under CRR Article 247(2);
- certain terms and conditions are not included in the credit risk transfer instruments, including those that (i) impose significant materiality thresholds below which credit protection is deemed not to be triggered if a credit event occurs; (ii) allow for termination of the protection due to deterioration of the credit quality of the underlying exposures; (iii) require positions in the securitisation to be improved by the originator (other than in the case of early amortisation provisions); (iv) increase the institution's cost of credit protection or the yield payable to holders of positions in the securitisation in response to deterioration in the credit quality of the underlying pool;
- a legal opinion is provided confirming that the credit protection is enforceable in all relevant jurisdictions;
- the securitisation documentation makes it clear that any purchase or repurchase of securitisation positions by the originator or sponsor beyond its contractual obligations may only be made on arm's length conditions;
- any clean-up call is exercisable at the option of the originator only when 10% or less of the value of the securitised exposures remains unamortised, and such call is not structured to provide credit enhancement.

### Application of a 1250% risk weight/CET1 deduction to retained securitisation positions

25. As the originator decides to apply a 1250% risk weight/CET 1 deduction on all positions it retains in relation to the transaction, there is no exposure to the risk of the transaction which is not already fully covered by regulatory capital. If the transaction is also compliant with the additional requirements specified in Art. 243(5) and Art. 244(5), no regulatory capital on the underlying exposures is therefore required.
26. While at first sight this option appears to be closely related to the SRT tests, the two requirements serve fundamentally different purposes. The rationale underpinning the SRT tests is specific to securitisations, whereas the deduction option sets forth a general principle that the risk associated with an exposure is deemed to be fully covered, if it is subject to CET1 deduction/1250% risk weight.

**Figure 2: Options for the originator in the securitisation framework to exclude the securitised exposures from the calculation of risk-weighted exposure amounts and expected loss amounts**





### 1.2.2 EBA Guidelines<sup>12</sup> and reporting to EBA on SRT

27. The CRR does not fully specify the regulatory or supervisory treatment of a number of issues with direct relevance for the SRT, or only addresses them in a partial or indirect manner. This is the case, for instance, with regard to the treatment of specific structural features of the transactions, such as excess spread, cost of credit protection, amortisation structure, call options and early termination events, or what procedural steps originators and competent authorities should follow the SRT assessments.
28. The EBA Guidelines on SRT published in July 2014 aim to provide additional guidance for both competent authorities and originators in terms of their assessments of the SRT, and hence to support a more consistent approach to SRT assessments across the EU.
29. The Guidelines cover the following aspects:
  - a. They specify requirements for competent authorities when assessing transactions that claim SRT. First, they include a list of criteria to help competent authorities to determine when to conduct a comprehensive review of the transaction. Second, they provide guidance on how to assess a number of aspects and structural features of the transaction which are either not treated in Level 1 or are only covered partially;
  - b. They set out requirements for originators when engaging in securitisation transactions for SRT, including requirements in relation to governance and risk management policies that are considered necessary for the recognition of SRT;
  - c. Finally, they also include a standard template for competent authorities to provide information to the EBA, on an annual basis, about all the transactions claiming SRT that have been subject to comprehensive review.
30. The SRT transactions reported to the EBA include, as a minimum, all the transactions that have been tested under the quantitative SRT tests and that exhibit any of the features in the list of criteria in the EBA Guidelines requiring the comprehensive assessment. They also include all the transactions that are permission-based, as it is understood that the comprehensive assessment is in any case necessary for all such transactions.
31. The EBA does not receive information on those SRT transactions on which competent authorities have not carried out a comprehensive assessment, nor on the transactions where the originator has applied the full deduction option in accordance with Art. 243/244(1)(b). It is however estimated that the notifications received by the EBA cover a substantial majority of the SRT transactions.

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<sup>12</sup> EBA Guidelines on SRT (July 2014): <http://www.eba.europa.eu/regulation-and-policy/securitisation-and-covered-bonds/draft-guidelines-on-significant-risk-transfer-srt-for-securitisation-transactions>

### 1.3 Changes to the regulatory treatment of SRT in the new EU securitisation framework

32. A few amendments have been introduced to the SRT-related provisions of the CRR in the context of the STS securitisation reform that is expected to enter into force at the beginning of 2018. The changes are not substantial as they maintain the concept of the SRT, its main principles as well as the amounts of risk that are required to be transferred to third parties under the quantitative SRT tests.
33. The framework introduces few targeted amendments in the following areas that are most relevant for SRT: (i) the first loss test; (ii) the definition of the mezzanine position.
34. The STS securitisation reform also modifies the text of the EBA mandate on SRT, which justifies and shapes the technical advice proposed in this Discussion Paper (see next section).

#### Changes to the first loss test

35. While the CRR refers to securitisation positions being subject to a 1250% risk weight or to deduction from CET 1, the new CRR refers to the 'first loss tranche'<sup>13</sup>. The new CRR maintains the requirement that a minimum of 80% of the exposure value of such tranche need to be transferred to third parties. This does not represent a substantial change and makes the text consistent with the new definition of the mezzanine position.

#### Changes to the definition of the mezzanine position

36. According to the new definition, mezzanine position means a position in the securitisation which is (i) subordinated to the senior securitisation position and more senior than the first loss tranche, and which is (ii) subject to a risk weight lower than 1250% and higher than 25%.
37. The new definition addresses a number of inconsistencies with respect to the existing definition of the mezzanine tranche (see Section 3.3 for further information). It no longer makes reference to ratings (the previous definition required subordination to CQS1/CQS2 positions). Also, given the fact that it explicitly requires the seniority of the mezzanine position over the first loss tranche, it also clarifies that the mezzanine test is applied to securitisation transactions with at least three tranches. All two-tranche securitisation transactions are therefore subject to assessment under the first loss test.

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<sup>13</sup> Due to the definition of a 'first loss tranche' provided in point (18) of Art. 2 of the new Securitisation Regulation ('first loss tranche' means the most subordinated tranche in a securitisation that is the first tranche to bear losses incurred on the securitised exposures and thereby provides protection to the second loss and, where relevant, higher ranking tranches), the first loss test may now also be applied with tranches meeting this definition but not being subject to a deduction from CET 1 and being subject to a risk weight lower than 1250%.

38. One implication of the Level 1 reference to the 25% - 1250% risk weight range is that it makes the designation of the mezzanine tranche dependent on the approach applied for the calculation of own funds requirements under the new hierarchy of approaches, as well as on the maturity of the transaction. For example, a tranche could be considered mezzanine given it has risk weights higher than 25% under SEC-SA and SEC-ERBA approaches, although not under SEC-IRBA approach, where the risk weights could be lower than 25%; or a tranche could be considered mezzanine under the SEC-ERBA, given its thickness adjustments, but not under the formulae-based approaches SEC-SA and SEC-IRBA; or a tranche could be considered mezzanine or not under SEC-IRBA or SEC-ERBA depending on whether the remaining maturity is 1 or 5 years, given that risk weights increase with the maturity.

## 1.4 EBA mandate on SRT

39. Art. 243(6) and 244(6) of the current CRR request the EBA to review the implementation of the EBA Guidelines on the significant risk transfer from July 2014, and to provide advice to the Commission by 31 December 2017 on whether a binding technical standard is required.
40. The amendments to the CRR, which have been put forward as a part of the new Securitisation Regulation, extend the mandate and request the EBA to specifically review a number of aspects with respect to the CRR. In particular, the new text requires the EBA's technical advice on:
- a. The conditions determining SRT in accordance with both the SRT quantitative tests and the permission-based SRT process;
  - b. The concept of 'commensurate' risk transfer, which competent authorities can invoke on a case-by-case basis to decide that significant risk is not considered to have been transferred;
  - c. The requirements for competent authorities when assessing SRT.
41. According to the new mandate, the Commission may adopt a Delegated Act, taking account of the EBA report. The text of the EBA mandates included in the current CRR as well as in the new EU securitisation framework is provided in Box 1.

**Box 1: EBA mandates on SRT in current and new CRR**
**Current CRR, Art. 243(6) and 244(6)**

EBA shall monitor the range of practices in this area and shall, in accordance with Article 16 of Regulation (EU) No 1093/2010, issue guidelines. EBA shall review Member States' implementation of those guidelines and provide advice to the Commission by 31 December 2017 on whether a binding technical standard is required.

**Proposed CRR amendments: compromise text resulting from the conclusion of the trilogue process**
Traditional securitisation (Art. 244(6) CRR)

EBA shall monitor the range of supervisory practices in relation to the recognition of significant risk transfer in traditional securitisations in accordance with this Article. In particular, EBA shall review the following items:

- a) The conditions for the transfer of significant credit risk to third parties in accordance with paragraphs 2, 3 and 4;
- b) The interpretation of "commensurate transfer of credit risk to third parties" for the purposes of the competent authorities' assessment provided for in the penultimate subparagraph of paragraph 2 and paragraph 3;
- c) The requirements for the competent authorities' assessment of securitisation transactions in relation to which the originator seeks recognition of significant credit risk transfer to third parties in accordance with paragraphs 2 or 3.

EBA shall report its findings to the Commission by [two years after entry into force of this Regulation]. The Commission may, having taken into account the report from EBA, adopt a delegated act in accordance with Article 462, to supplement this Regulation by further specifying the items listed in points (a) to (c) of this paragraph.

Synthetic securitisation (Art. 245(6) CRR)

Same language as for traditional securitisation.

42. The EBA work on SRT has been conducted in line with the mandate in the new CRR. The EBA publishes this Discussion Paper to gather stakeholders' views on the EBA assessment and proposals with respect to various elements of the SRT. The feedback received in response to this Discussion Paper will serve as an input in preparations of the final EBA report on SRT which shall be provided to the Commission at the latest within two years after the entry into force of the new securitisation framework. The final EBA report will be based on the new securitisation framework which will have entered into force in the meantime. In line with the regulatory mandate, the EBA will continue to perform its regular monitoring role in relation to the range of supervisory practices on the recognition of SRT.

## 2. Overview of market and supervisory practices with respect to SRT

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*This chapter provides a quantitative overview of all 49 SRT transactions that have claimed SRT between July 2014 and December 2016 and have been reported by competent authorities to the EBA, in accordance with the EBA Guidelines. It also provides a short summary of supervisory practices and frameworks in relation to the SRT assessment existing across the European Union, based on the responses by 23 competent authorities to a 2016 EBA questionnaire. Detailed analysis of both market and supervisory practices with respect to the SRT is provided in the Annexes to the Discussion Paper.*

### 2.1 Overview of market practices in relation to SRT

43. According to the EBA Guidelines, competent authorities have to report to the EBA, using the Annex 1 template attached to the EBA Guidelines, each securitisation transaction on which the EBA Guidelines require the competent authorities to conduct a comprehensive assessment. The competent authorities report to the EBA on an annual basis. As the Guidelines entered into force in July 2014, the EBA has so far received two sets of notifications: the first one covering the period July 2014-December 2015, and the second one covering the year 2016.
44. It is estimated that the notifications received by the EBA cover at least 80% of all the SRT transactions<sup>14</sup> that have taken place in the market and that have been assessed by the competent authorities under the SRT framework, i.e. either under the quantitative SRT tests or the permission-based SRT procedure (respectively, CRR Art. 243(2)/244(2) or Art. 243(4)/244(4)).
45. During the reporting period, the EBA received feedback from competent authorities covering 11 jurisdictions (DE, ES, FI, IE, IT, LU, PT, RO, SE, UK, SSM). Altogether, 49 SRT transactions have been notified from 4 jurisdictions (IT, SE, UK and SSM<sup>15</sup>)<sup>16</sup>. 7 jurisdictions (DE, ES, FI, IE, LU, PT and RO) informed that there were no transactions which would need to be reported according to the EBA Guidelines.

<sup>14</sup> Outside of the scope of notification to the EBA are (i) securitisation transactions for which the EBA Guidelines do not require to conduct a comprehensive assessment, in which case they are notified to/assessed by the competent authorities but are not notified to the EBA; and (ii) transactions to which the full deduction option is applied under CRR Art. 243(1)(b) or Art. 244(1)(b), in which case they are not notified neither to the respective competent authority nor to the EBA.

<sup>15</sup> SSM notified transactions covering the following jurisdictions in 2016: IT, FR, DE, ES, NL and IE.

<sup>16</sup> Some CAs have informed that a number of transactions have taken place outside of the reporting period.

**Figure 3: SRT transactions requiring notification in accordance with the EBA Guidelines: number of transactions and jurisdictions**

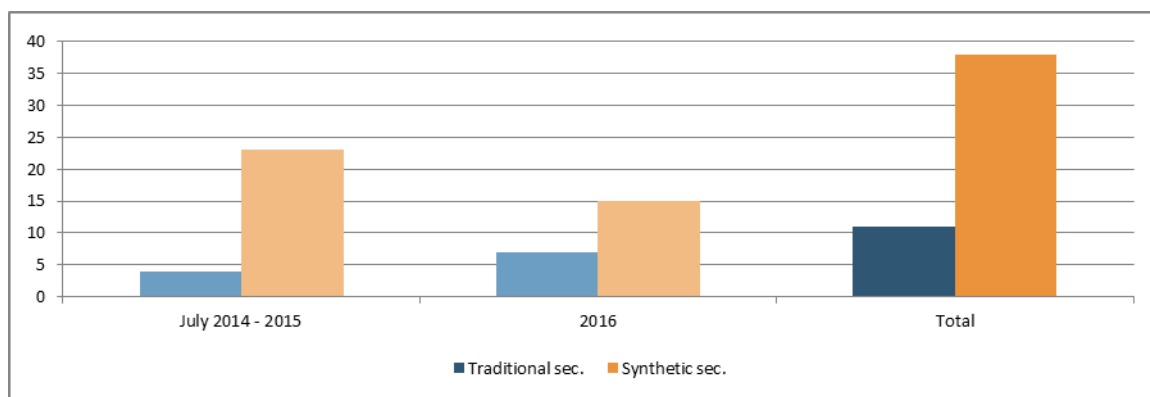
	July 2014 to 2015	2016	Total
Feedback received	6 jurisdictions	11 jurisdictions	11 jurisdictions
Number of SRT transactions	27 (IT, UK, SSM)	22 (SE, UK, SSM)	49 (IT, SE, UK, SSM)

46. A significant majority of transactions that claimed SRT were synthetic securitisations (38 transactions, representing 85% of the total notional value of all reported transactions). 11 transactions out of 49, representing 15% of the total notional value, were traditional securitisations.
47. According to the data from the SRT notifications, for all traditional securitisation transactions and for a significant majority of synthetic securitisation transactions, the SRT was achieved based on the quantitative tests, i.e. according to CRR Art. 243(2) and 244(2). Only for 3 synthetic transactions, the SRT was demonstrated based on other evidence provided by the originator in accordance with CRR Art. 244(4), indicating a limited use of the permission-based SRT approach in practice.

**Figure 4: Traditional vs synthetic securitisation: number of SRT transactions and notional value<sup>17</sup>**

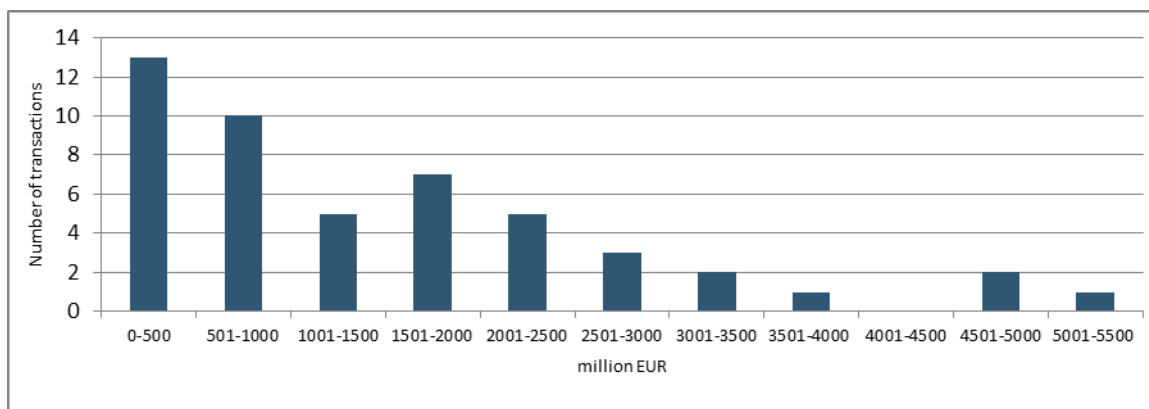
	July 2014 to 2015		2016		Total	
	Number of transactions	Transaction notional (m EUR)	Number of transactions	Transaction notional (m EUR)	Number of transactions	Transaction notional (m EUR)
<b>Traditional sec. (Art. 243)</b>	<b>4</b>	<b>4 111</b>	<b>7</b>	<b>6 671</b>	<b>11</b>	<b>10 781</b>
Art. 243(2)	4	4 111	7	6 671	11	10 781
Art. 243(4)	0	0	0	0	0	0
<b>Synthetic sec. (Art. 244)</b>	<b>23</b>	<b>44 748</b>	<b>15</b>	<b>19 375</b>	<b>38</b>	<b>64 123</b>
Art. 244(2)	20	31 018	15	19 375	35	60 393
244(4)	3	3 730	0	0	3	3 730
<b>Total</b>	<b>27</b>	<b>48 859</b>	<b>22</b>	<b>26 046</b>	<b>49</b>	<b>74 904</b>

**Figure 5: Number of SRT transactions (traditional vs synthetic securitisations)**



<sup>17</sup> Conversion rates of January 2017 have been used for converting notional amounts for transactions notified in GBP and USD.

Figure 6: Number of SRT transactions per size bucket (million EUR)

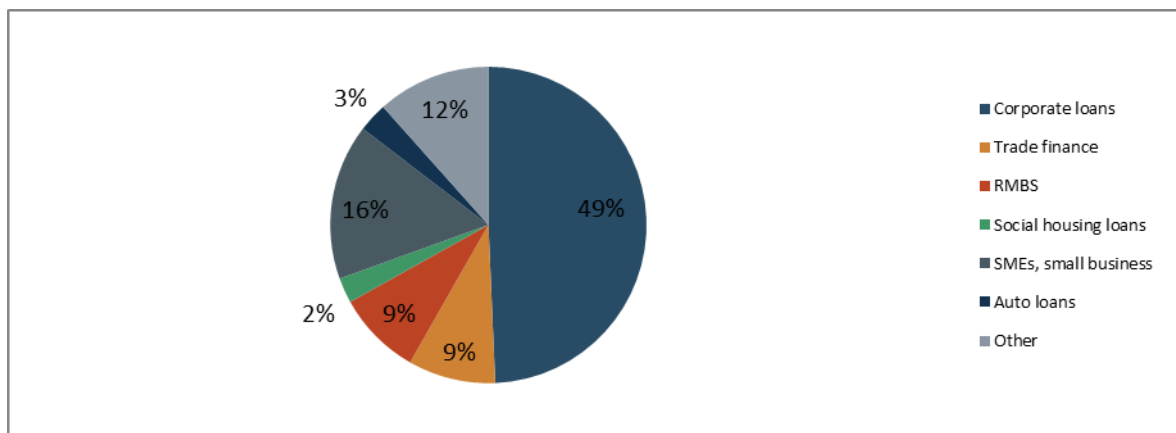


48. The total notional value of the securitisation transactions claiming SRT that were reported to the EBA was 74.9 bn EUR for the period July 2014-December 2016. The size of the reference portfolio in the SRT transactions is 76.2 bn (45.5 bn EUR from July 2014 to 2015, and 30.7 bn EUR in 2016). Almost half of the transactions (23 out of 49) have a notional value in a range from 5 to 1000 m EUR. The notional value of the smallest transaction was 5.53 m EUR, the largest one was 5048 m EUR.
49. Corporate loans were the most widely used type of collateral in terms of notional: 19 transactions, representing almost 50 % of the notional value, were collateralised by corporate loans. The second most used type of collateral was loans to SME and small businesses. There has been an increase in the transactions backed by these types of loans: in 2015 only 4 transactions, representing 3.94% of the overall value, were securitisations of loans to SME and small businesses, while in 2016 it was 8 transactions altogether, representing almost 16% of the total notional value of all the transactions, respectively. This has been followed by transactions collateralised by trade finance exposures (2 transactions, 8.94%) and by residential mortgage-backed securities (RMBS, 6 transactions, 8.67%).

Figure 7: Type of collateral and notional value of the SRT transactions

Type of collateral	July 2014 to 2015			2016			Total		
	Transaction notional (mn. EUR)	% of total transaction notional	Number of transactions	Transaction notional (mn. EUR)	% of total transaction notional	Number of transactions	Transaction notional (mn. EUR)	% of total transaction notional	Number of transactions
Corporate loans	25 868	52.95%	11	11 067	42.49%	8	36 935	49.31%	19
SMEs, small business	3 040	6.22%	4	8 886	34.12%	8	11 925	15.92%	12
Trade finance	6 696	13.71%	2	0	0.00%	0	6 696	8.94%	2
Residential mortgages	4 111	8.41%	4	2 381	9.14%	2	6 491	8.67%	6
Auto loans	0	0.00%	0	2 241	8.60%	3	2 241	2.99%	3
Social housing loans	1 927	3.94%	1	0	0.00%	0	1 927	2.57%	1
Other	7 217	14.77%	5	1 471	5.65%	1	8 688	11.60%	6
<b>Total</b>	<b>48 859</b>	<b>100%</b>	<b>27</b>	<b>26 046</b>	<b>100%</b>	<b>22</b>	<b>74 904</b>	<b>100%</b>	<b>49</b>

Figure 8: Type of collateral, as % of notional value, for total number of reported transactions

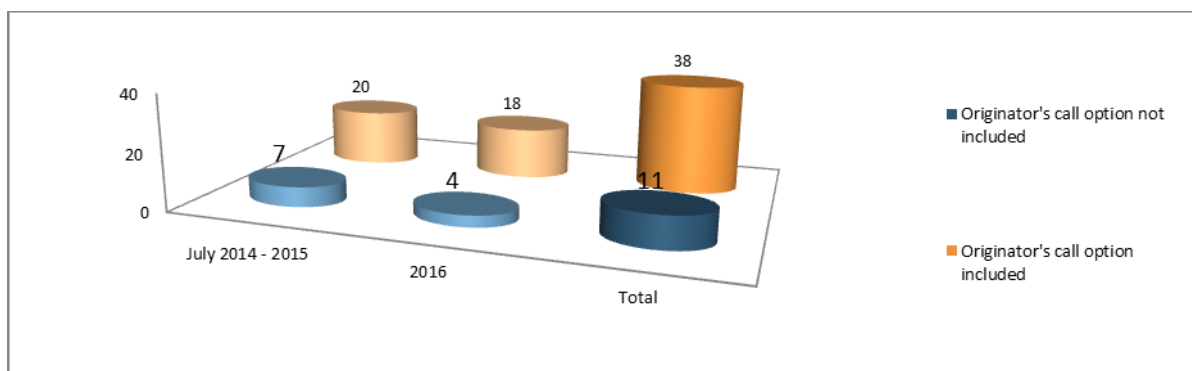


50. A majority of the transactions include an originator's call option (38 transactions, 76% of total number of transactions), allowing the originator to call the transaction upon occurrence of predefined contractually agreed conditions. Based on the qualitative information included in the notifications regarding the type of the call options, the clean up call is the most widely used type of call, incorporated in the documentation of approximately one third of the transactions. Regulatory calls are included in at least one fifth of the transactions. Time calls have been used only in a limited number of transactions.

Figure 9: Originator's call options included in the SRT transactions

Originator's call options included	July 2014 to 2015		2016		Total	
	Number of transactions	% of transactions	Number of transactions	% of transactions	Number of transactions	% of transactions
Yes	20	74%	18	82%	38	76%
No	7	26%	4	18%	11	24%

Figure 10: Originator's call options included vs not included

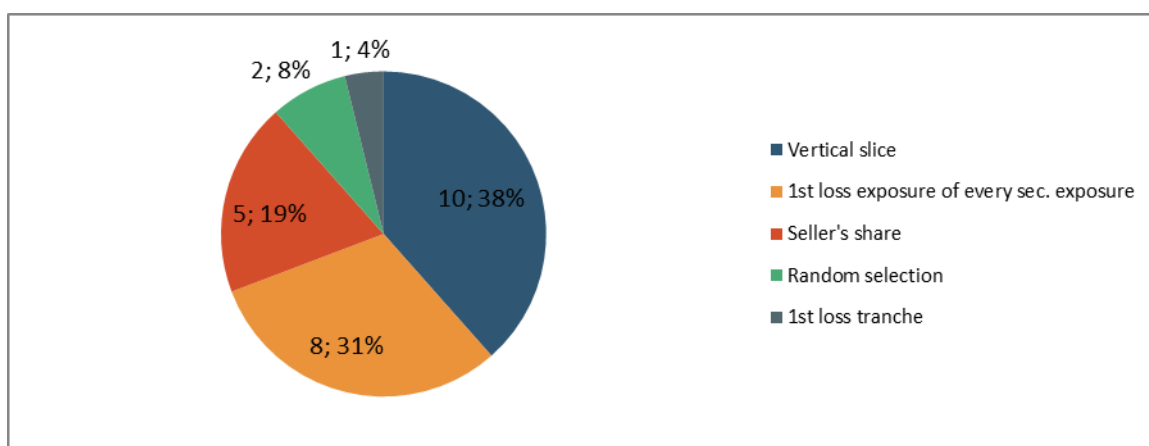


51. As regards risk retention, the retention via vertical slice (i.e. minimum retention of 5% of each tranche, as per Art. 405(1)(a) CRR) is the most widely used type of retention (10 transactions), followed by the minimum retention of 5% of the first loss exposure of every securitised exposure, as per Art 405(1)(e) CRR (8 transactions), retention of seller's share



i.e. a minimum retention of 5% of the nominal value of securitised exposures for securitisations of revolving exposures, as per. Art 405(1)(b) CRR (5 transactions). Retention of randomly selected exposures (Art. 405(1)(c) CRR) and retention of a first loss tranche (Art. 405(1)(d) CRR) have been used in a very limited number of cases (2 transactions and 1 transaction respectively). There has not been any pattern observed in terms of the relation between the type of retention, the type of transaction and the type of collateral. It should be noted that the information on the risk retention has been reported on a voluntary basis, in 26 out of 49 transactions.

**Figure 11: Risk retention: number and percentage of transactions per each type of risk retention (for 26 out of 49 transactions)**



52. Most of the transactions include blind pools, i.e. the identity of the obligors in the securitised exposures is not disclosed to investors, due to commercial, confidentiality, data protection and other reasons. Typically, the more granular the portfolio is, the higher the probability is that the pool is blind. Disclosed pools are used in some transactions, normally in portfolios with a relatively small number of large exposures, such as large corporate or project finance loans.
53. See Annex 2 for additional analysis of market practices, including with respect to the quantitative testing of the transferred risk, and Annex 3 for additional data on the SRT transactions gathered from the notifications to EBA according to the EBA Guidelines.

**Question 1: Does the data on synthetic and traditional SRT securitisation transactions correspond with your assessment of the SRT market activity in the EU? Do you have any observations on these data?**

## 2.2 Overview of supervisory frameworks for assessment of SRT

54. The EBA has conducted a detailed analysis of different supervisory frameworks for the assessment of SRT in the EU<sup>18</sup>, with a specific focus on four main areas:
- a. First, it reviews processes applied by competent authorities in individual jurisdictions in various phases of the SRT assessments;
  - b. Second, it investigates how competent authorities assess some specific characteristics of the SRT transactions that, according to the EBA Guidelines, trigger a comprehensive assessment of SRT transaction, such as with respect to the thickness of the tranche used to demonstrate the SRT, or use of ECAI ratings;
  - c. Third, it looks into the supervisory assessments and expectations in relation to specific structural features observed in the market practice. The analysis looks in particular on the following aspects: amortisation structure, call options, excess spread, cost of credit protection, other early termination events, credit events, replenishment mechanisms, substitution/reinvestment of assets, repurchase transactions by the originator, discounted asset sales, and maturity and currency mismatches;
  - d. Lastly, the analysis reviews other aspects considered by competent authorities as part of their SRT assessments, such as use of the supervisory formula method and external IRB models, originator's knowledge of underlying exposures and internal policies for assessing SRT, connections between originator and third parties, transaction documentation, type of credit protection, and accounting treatment.
55. The analysis indicates that a significant level of heterogeneity exists among the individual frameworks in a number of areas with direct relevance for the SRT, reflecting, among other, the lack of detailed regulatory treatment at EU level.<sup>19</sup>
56. Within the context of the EBA guidelines, different approaches have been observed in particular in relation to the procedural aspects of the supervisory assessment of SRT, in various phases and steps of the process, including with respect to the requirements on the notification/application for SRT that the originator submits to the competent authority, and the type and timing of the feedback provided by the competent authority to the originator regarding the achievement of SRT. Both areas are considered crucial in determining the overall efficiency of the SRT assessment process.

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<sup>18</sup> The analysis has been based on the information collected through a questionnaire to competent authorities in 2016, to which 23 competent authorities responded.

<sup>19</sup> Differing practices may also partly be the result of very little to no securitisation issuance in certain jurisdictions, leading to consistent supervisory practices not being developed.

57. Heterogeneity has also been observed in the supervisory assessments of a selected number of structural features of securitisation transactions, which are considered particularly relevant from the SRT perspective given they have potential to undermine the claimed credit risk transfer to third parties and affect the sustainability of risk transfer through the life of the transaction. These aspects include the amortisation structure, call options, excess spread, cost of protection, other early termination events and credit events.
58. In other areas, the observed differences have either been less substantial from the perspective of the impact on SRT, or the practices have been found fairly homogeneous.
59. The EBA review also provides an overview of supervisory frameworks for SRT assessments across Europe. It indicates that formal supervisory frameworks for SRT assessment exist in 5 out of 23 jurisdictions (DE, IT, LU, UK and SSM). The SRT frameworks in these jurisdictions supplement the EBA Guidelines, detailing aspects of the SRT assessment, with differences in the level of detail and comprehensiveness.
60. A number of jurisdictions which are part of the SSM made a reference to the ECB/SSM methodology for SRT assessments (BE, EE, ES, FR, IE, NL and PT). It is understood that their SRT frameworks for less significant institutions (LSIs) refer to or are aligned with the SSM methodology for significant institutions (SIs).
61. Eleven competent authorities informed that no supplementary framework for SRT assessment exists in their jurisdictions. Their SRT assessments are based on a case-by-case approach, in accordance with the EBA Guidelines, often reflecting limited securitisation activity in the relevant jurisdiction. This is specifically the case of AT, CZ, CY, DK, EL, FI, HU, LT, SI, SK and SE.

**Figure 12: Overview of supervisory frameworks on SRT**

Supervisory framework on SRT	Number of jurisdictions	Jurisdictions
Supplementary SRT supervisory framework in place	5	DE, IT, LU, UK, SSM
No supplementary SRT supervisory framework in place	11	AT, Cy, Cz, DK*, EL, FI, HU, LT*, SE*, SI, SK
SRT framework aligned to the SSM guidance	7	BE, EE, ES, FR, IE, NL, PT

NOTES: (\*) The competent authority envisages to implement a supplementary SRT framework in the future, or is currently in the process of implementation of such supplementary framework.

62. See Annex 1 for a detailed analysis of supervisory frameworks for the assessment of SRT in all the above mentioned areas.

**Question 2: Are you aware of any material supervisory practices that have not been covered in the EBA analysis?**

### 3. Assessment of SRT and EBA proposals for discussion

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*As a result of the analysis and review of supervisory and market practices, the EBA puts forward a number of initial proposals for discussion in view of addressing the identified regulatory limitations and heterogeneity of supervisory approaches, with the ultimate objective to enhance the regulatory and supervisory level playing field with respect to SRT, enhance regulatory certainty in the area of SRT assessments and strengthen the prudential SRT framework. The EBA proposals are focused on three core areas: (i) process of SRT assessment by competent authorities; (ii) SRT assessment of complex structural features of securitisation transactions; and (iii) quantitative SRT tests.*

*The proposals in relation to the process of the SRT assessment are aimed at facilitating the SRT process for both originators and competent authorities. They are focused on specifying in a standardised manner for the EU the following aspects:*

- a) A requirement of ex-ante notification of the SRT transaction by the originator to the competent authority;*
- b) A requirement for the competent authority to provide feedback within a reasonable timeframe after the submission of the final version of all information/documentation;*
- c) A requirement for the originator to notify the competent authority in a pre-specified set of circumstances, and in any case on a quarterly basis, to share ongoing monitoring of the SRT status of the transaction;*
- d) An amended version of the SRT monitoring template (currently annexed to the EBA Guidelines), updated to take into account relevant new elements of the new EU securitisation framework as amended by the 2017 STS securitisation reform.*

*The proposals relating to the specific structural features of securitisation transactions are aimed at ensuring the sustainability of the SRT throughout the lifetime of the transaction. Depending on the structural feature under consideration, these proposals introduce specific conditions/constraints that the transaction characterised by that structural feature should meet. The structural features in the focus are the following:*

- a) In the case of either traditional or synthetic transactions: pro-rata amortisation schemes, call options and excess spread features;*
- b) In the case of synthetic transactions: the specification of credit events, termination clauses other than call options (i.e. other early termination events), and the cost of credit protection.*

*In addition, it is proposed that the originator accompanies its SRT notification with the results of a risk transfer self-assessment exercise (i.e. a stress test) aimed at quantifying the extent of risk transfer on a lifetime basis, always in the case of synthetic transactions and, in the case of traditional transactions, where the transaction presents the identified complex structural features. The originator's self-assessment exercise mimics a stress test exercise under appropriately specified conservative scenarios to model the risk factors that are relevant to each complex structural feature.*

*The proposals related to the quantitative SRT tests are aimed to address certain identified limitations of the existing framework as well as to respond to the mandate included in the new CRR on further specifying the concept of commensurate risk transfer. The EBA aims to gather stakeholders' views on two options to complement (Option 1) or complement/potentially modify (Option 2) the new CRR SRT framework:*

- a) Option 1: firstly, by specifying a minimum thickness requirement of the first-loss tranche; and secondly, introducing a new quantitative test of commensurate risk transfer comparing the potential reduction in own funds requirements achieved by the originator with the share of total portfolio losses that are transferred to third party investors;*
- b) Option 2: introducing a new test that has both a significant risk transfer and a commensurate risk transfer component, based on the comparison between post-securitisation own funds requirements on retained positions and pre-securitisation underlying risk.*

*This section provides a detailed assessment of SRT considerations from supervisory, regulatory and market perspective in each of these three core areas, and presents the proposals/options under consideration following this assessment, to the stakeholders for comments.*

## 3.1 Assessment and proposals for discussion in relation to the SRT process

### 3.1.1 Supervisory and market approaches to the process of SRT assessment

63. Currently, the EU regulatory framework (CRR, EBA Guidelines) does not set out rules on the process of the SRT assessment. The analysis of supervisory practices and market experience demonstrates the existence of diversity in the supervisory practices as regards the procedural aspects of SRT assessments. Heterogeneity has been identified in particular with respect to (i) the requirements on the notification/application for SRT that the originator submits to the competent authority; (ii) the type and timing of the feedback provided from the competent authority to the originator regarding the achievement of SRT; and (iii) other types of notifications required by the competent authority.
64. As regards the market perspective, originators note a general satisfaction with the supervisory processes of SRT assessments. Nevertheless, a number of suggestions for improvement were proposed to further enhance the efficiency of the process. The need for further harmonisation and transparency of supervisory approaches was widely supported. Intensive and active discussions with the competent authorities throughout the supervisory assessment were highly appreciated, while differences in the approaches of individual competent authorities have been noted in this regard.
65. As a result of the review, the EBA has identified a few priority areas where heterogeneity exists in supervisory practices, and where further standardisation is considered crucial for enhancing the efficiency of the SRT assessment process. EBA proposals are aimed to ensure a proper balance between the enhancement of the regulatory level playing field and market certainty on the one hand, and the need to ensure sufficient flexibility and discretion in the internal and decision-making supervisory processes, on the other.

#### Deadline for the originator's notification of the SRT transaction

66. Practices are variable across Europe with respect to the originators' notifications of SRT transactions, in particular as regards the timeline for submissions of the SRT notifications to competent authorities. While in a majority of jurisdictions the notification is required ex ante, some jurisdictions only require the notification after the origination of the transaction/execution of the transfer. In those cases where ex ante notification is required, deadlines for the notification are different in each case, extending to up to three months before the expected closing date of the transaction.
67. On the one hand, longer notice periods facilitate the comprehensive analysis of the transactions by the competent authorities. On the other hand, important features of the transaction (such as documentation, structure and pricing) may only be finalised shortly in advance of the execution of the transaction. This could result in a notification of a transaction that could look significantly different at the point of execution, and could

increase the procedural burden for both the originators with submission and for the competent authorities with reassessment, of the final documentation.

### Feedback by the competent authority on the achievement of SRT

68. Practices differ considerably as regards the feedback provided by competent authorities on the achievement of SRT, both as regards the type and timing of such supervisory response. While in a majority of jurisdictions the feedback is provided both in case of positive and negative SRT assessment, in some jurisdictions it is only given in case the SRT has not been granted. Alternatively, some of the supervisory frameworks do not envisage provision of any feedback. The type of the response may be based on explicit positive/negative SRT validation, or on non-objection procedure.
69. Practices vary considerably also with respect to the timing of the feedback. In some cases feedback may be provided ahead of the execution of the transaction, in other cases after the closing. In some frameworks the deadlines are fixed in the supervisory frameworks, while in a number of jurisdictions no specific deadlines are provided and the timing of the feedback is based on a case-by-case approach.
70. While on the one hand a sufficient level of flexibility is necessary for the competent authorities to conduct a thorough assessment of each individual SRT transaction particularly considering the different degrees of complexity of securitisation transactions, lengthy feedback procedures may result in a high degree of uncertainty for the market. A number of market participants highlighted the importance of establishing more clarity on the timing of the supervisory feedback, some of them particularly emphasizing the advantages of receiving feedback ahead of the closing of the transaction (taking into account the SRT decision may have important consequences on the structuring of the transaction). Provision of informal early feedback at the early phases of preparation of the transaction has also been positively evaluated by market participants (without prejudice to the right of the competent authority to consider the transaction as non-SRT compliant at a later stage).

### Other notifications

71. Inconsistencies have been found also with respect to other notifications required from originators to competent authorities, in particular as regards the triggers and conditions for such notifications. These may include changes to the initially agreed contractual conditions on SRT, modifications in characteristics of the SRT transaction, or any changes that have impact on significant and/or commensurate risk transfer. In some jurisdictions, notifications are required in relation to the exercise of different call options, either ahead or after the exercise of the calls. In addition, the application of the so-called full deduction option by the originator is currently not subject to notification requirements, neither to competent authorities nor to EBA, leading to a lack of information on the application of this regulatory treatment in practice.

### Ongoing monitoring of the SRT

72. No harmonised processes exist regarding the ongoing monitoring of the SRT compliance. While in some jurisdictions originators are required to inform the competent authorities of the evolution of the transaction on a regular basis, in other jurisdictions a review of the transactions is performed on an ad hoc basis and no specific information requirements apply. While the firms have responsibility of ensuring compliance with SRT requirements on an ongoing basis, the provision of information on a regular basis on the evolving characteristics of the transaction is will facilitate ongoing supervisory assessment of the SRT.

### Further standardisation of the SRT assessment process

73. It could be envisaged to streamline the existing SRT templates (such as the SRT notification template submitted by competent authorities to EBA, as included in the EBA Guidelines), or to possibly introduce standardised templates/checklists for originators, such as a template for originators to notify competent authorities of a given SRT transaction, or to report information on an already existing transaction in respect of that transaction, in order to further enhance the standardisation of the SRT process. The EBA welcomes suggestions to ensure the proportionality of any such reporting.



### 3.1.2 EBA proposals for discussion on the SRT process

74. *As a result of the reviewed market practices and range of supervisory practices in relation to the process of the SRT assessment, it seems appropriate to further standardise the process in the following core areas:*
- a. ***SRT notification to the competent authority:*** *a formal notification framework should be established, requiring ex ante notification by the originator of the SRT transaction at the latest 1 month before the expected issuance. Key information/documentation should be submitted within such ex-ante notification. The originator should provide a final version of all information/documentation no later than 15 days after the closing date of the transaction.*
  - b. ***Supervisory feedback on SRT to the originator:*** *the competent authority should provide an explicit point in time feedback to the originator on whether the SRT has been achieved or not, for each notified SRT transaction. Where no permission is required because one of the quantitative tests is used to demonstrate SRT, the feedback should include a statement of non-objection or objection to the transaction and should be provided within a reasonable timeframe after the submission of the final version of all information/documentation.*
  - c. ***Additional notifications to the competent authority in case of specific events:*** *the originator should submit a notification to the competent authority in the following cases:*
    - I. *In case of changes in the characteristics of the transaction that impact on the risk transferred, as a minimum in case of changes to the initially agreed conditions, or characteristics of the SRT transaction, or in case the SRT requirements are no longer fulfilled;*
    - II. *Ahead of the exercise of any call option included in the transaction documentation. The notification on the exercise of time calls, in particular, should include an analysis evidencing that the exercise of the time call would provide no support to the investors;*
    - III. *In case of application of the so-called full deduction option to a specific transaction (i.e. application of 1250% risk weights/CET1 deduction to retained securitisation positions according to Art. 243/244(1)(b) CRR), the originator should notify the competent authority, and the competent authority should inform the EBA of all the notifications received from originators on the use of such option in their jurisdiction, on an annual basis.*
    - IV. *In addition, originator should also notify without undue delay of any*

*event affecting or likely to affect the effectiveness of an SRT for a particular transaction. This obligation is without prejudice to the provision on implicit support laid down in Article 248 of the CRR.*

- d. **Additional notifications to the competent authority for the purposes of ongoing monitoring of the SRT compliance:** *the originator should inform the competent authority of material changes to the transaction which would affect the achievement of SRT and provide relevant information on ongoing SRT compliance, at least on a quarterly basis.*

*The EBA is also considering to update and further streamline the **template on the SRT notification** provided by the competent authority to EBA, to take account of the new securitisation framework and the experience with the existing templates (e.g. it could be envisaged to (i) provide guidance on how to calculate some of the data points in the template such as capital reduction claimed, capital reduction achieved, EL, etc.; and (ii) insert additional data points in the template such as on the method used for calculating own funds requirements under both the credit risk and the securitisation framework; the type of SRT test used; UL, KIRB and KSA; form of retention of net economic interest, etc.).*

**Question 3:** *What are your views on the proposals on the standardisation of the SRT assessment process set out above? Are any other changes necessary to further improve the process?*

**Question 4:** *Could you provide suggestions as to whether and how the template for SRT notification by the competent authority to EBA provided in Annex I of the EBA Guidelines<sup>20</sup> should be amended to reflect the new EU securitisation framework and the STS securitisation product?*

**Question 5:** *Should a standardised SRT notification template be developed, for submission by originators to competent authorities, in order to facilitate the SRT assessment process? If yes, should this template be different for traditional and synthetic securitisation? (Please provide examples of templates, as appropriate).*

**Question 6:** *Could you provide suggestions as to how a template for monitoring SRT compliance should look like (e.g. by potential amendments of the current COREP templates)?*

<sup>20</sup> See Annex I in the EBA Guidelines, available at: <https://www.eba.europa.eu/documents/10180/749215/EBA-GL-2014-05+Guidelines+on+Significant+Risk+Transfer.pdf>.

## 3.2 Assessment and proposals for discussion with respect to selected structural features of SRT transactions

### 3.2.1 Assessment of selected structural features of SRT transactions

75. The EBA Guidelines indicate that the SRT requirements should be met on a continuous basis, i.e. not only when the originator first excludes the securitised exposures from the calculation of risk-weighted exposure amounts, but rather during the whole life of the transaction. In order to ensure ongoing compliance, the EBA Guidelines provide that originators put in place the appropriate systems and governance for the ongoing monitoring of significant risk transfer and competent authorities monitor such compliance regularly.
76. The objective of ensuring compliance with SRT requirements on a continuous basis is twofold: (i) on the one hand it ensures that originators' regulatory capital ratios appropriately reflect at all times the actual risk to which originators are exposed in the context of their securitisation activities; (ii) on the other hand it ensures that the originators' own funds requirements related to securitisation remain, to the extent possible, reasonably stable over time.
77. Securitisation transactions, both traditional and synthetic, may embed structural characteristics that are potentially detrimental to compliance with SRT requirements on a continuous basis. The importance of specific structural characteristics is acknowledged in the EBA Guidelines, whereby reference to certain characteristics is made in, at least, the following sections:
  - a. The conditions under which competent authorities should carry out a comprehensive assessment of the transaction (Title II – Section 3 of the EBA Guidelines);
  - b. Structural features within the comprehensive assessment of SRT (Title III – Section 5 of the EBA Guidelines);
  - c. Credit protection issues within the comprehensive assessment of SRT in synthetic transactions (Title III – Section 7 of the EBA Guidelines).
78. The EBA's review of both SRT market practices and the supervisory approaches to SRT assessments, as illustrated in this Discussion Paper, highlights the need to further pin down the SRT implications of certain structural features and their treatment within the supervisory assessments of SRT. The objectives of providing further supervisory clarity in this space are, at least, the following:

- a. Strengthening the prudential framework governing significant risk transfer in the EU, thus further limiting the scope for regulatory arbitrage in structuring securitisation transactions;
  - b. Enhancing regulatory certainty and clarity with regard to the existing provisions and EBA Guidelines related to SRT, to increase market participants' understanding of and confidence in the regulatory framework;
  - c. Making the supervisory assessment of SRT more harmonised across Member States, thus enhancing the regulatory level playing field within the European market for securitisations;
  - d. Facilitating the supervisory activity of comprehensive assessment of securitisation transactions seeking SRT.
79. The structural features for which further regulatory specifications are needed go beyond those mentioned in the EBA Guidelines and encompass the following:
- a. Amortisation structure;
  - b. Call options;
  - c. Excess spread;
  - d. Cost of protection (synthetic securitisation);
  - e. Other early termination events (synthetic securitisation);
  - f. Credit events (synthetic securitisation).
80. The proposed way to strengthen the supervisory treatment of the above mentioned structural features is twofold:
- a. Firstly, a set of structural safeguards in relation to each structural feature under consideration is proposed. In the presence of the proposed safeguards, the comprehensive assessment of the securitisation transaction by the competent authority should become more harmonised across Member States and should result in a smoother and facilitated process, leading to - other things being equal - an increase in the likelihood of SRT being granted. Where the transaction does not feature the safeguards that are relevant to its structure, as proposed in this Discussion Paper, other things being equal, it is more likely that SRT may not be granted;
  - b. Secondly, it is proposed that originators submit to the competent authority a risk transfer self-assessment, to accompany their SRT notification, whenever the securitisation transaction features elements (a) to (c), above, and in any case for

synthetic securitisation transactions. The proposed self-assessment should in such cases support the request for SRT recognition.

81. It is important to note that not all SRT securitisation transactions happening in the market are expected to embed the specific structural safeguards discussed in this chapter, nor should all applications for SRT recognition reach the level of analytical complexity associated with the risk transfer self-assessment exercise. This chapter highlights a series of features that may be included in a securitisation transaction while impacting on its SRT status, and suggests an enhanced regulatory/supervisory framework to be implemented only in the presence of those features.
82. Securitisation transactions that are issued in accordance with more plain vanilla structures may follow the baseline SRT application and recognition process, with no need to additionally and specifically address structural complexities by requiring submission of an additional risk transfer self-assessment.

### 3.2.2 Amortisation structure

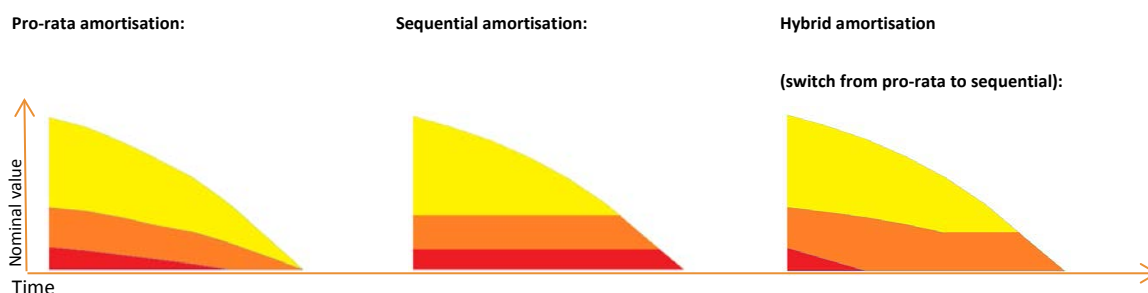
#### Review of practices

83. The amortisation structure of a securitisation transaction is the set of rules determining the order and schedule according to which all investors in the securitisation are repaid principal amounts.
84. In terms of schedule, transactions may amortise immediately from closing or may feature an initial limited revolving period, i.e. a period during which collections of principal amounts are used to purchase additional exposures, keeping the notional amount of the pool of securitised exposures constant. Specific transaction structures use bullet payment schedules, which may in turn take the form of soft (i.e. extendible) or hard (non-extendible) bullets.
85. In terms of priority of payments, securitisation transactions use one of the following schemes:
  - a. **Sequential priority scheme:** principal payments are allocated to senior tranches first, and to junior tranches only as the senior tranches are fully redeemed;
  - b. **Pro-rata priority scheme:** principal payments are allocated pari passu to all outstanding tranches, whereby each tranche receives an amount that is proportionate to the tranche's relative share in the transaction;
  - c. **Hybrid scheme (pro-rata to sequential):** the pro-rata amortisation scheme is usually the starting scheme, with specific contractual triggers determining the switch to the sequential scheme. The triggers are usually related to the

deterioration of the underlying exposures' performance. In this respect, among others, the following trigger conditions, or a combination of them, are observed in the market practice:

- i. Cumulative losses are higher than the cumulative expected losses reported by the originator;
  - ii. Cumulative losses are higher than a contractually defined cap (e.g. 1.5% of initial portfolio balance);
  - iii. The cumulative nominal value of exposures subject to non-matured defaults (i.e. exposures on which default has occurred and for which the work out of losses is still to be completed) is equal to or higher than the nominal outstanding value of the protected tranche of a synthetic securitisation.
- d. **Hybrid scheme (sequential to pro-rata):** transactions may also be structured to start with a sequential priority scheme that switches to pro-rata when trigger conditions are fulfilled. Such triggers flag the point in time at which the senior tranche of the transaction becomes equal to or lower than a given % portion of the outstanding portfolio balance, indicating decreasing economic efficiency within the transaction. This amortisation scheme may equally feature performance triggers that would require the switch back to the initial sequential structure in case of worsening portfolio performance.

Figure 13: Different types of amortisation structure



86. In both traditional and synthetic securitisations, the amortisation structure is one of the key structural choices determining the economic efficiency of the securitisation transaction.
87. Particularly in synthetic securitisations, the economic efficiency of the transaction evolves differently depending on the chosen priority scheme:
  - a. **Sequential priority scheme:** as the most senior tranches gradually amortise with the underlying portfolio, the notional outstanding of the mezzanine and/or junior tranches over which credit protection has been purchased remains constant (or partly reduces if credit events materialise). As a result, the cost of protection

(which equals a fixed percentage of the outstanding protected tranches) gradually increases as a share of the total outstanding pool of exposures and total income generated by the pool of exposures. In the same context, the cost of protection gradually increases as a fraction of the regulatory capital relief that the originator achieves with SRT recognition (to note that such effect may be mitigated/reinforced by some increase/decrease of regulatory capital on the underlying portfolio as a result of credit risk migration in the portfolio).

- b. **Pro-rata priority scheme:** as the underlying pool of exposures amortises, all outstanding tranches of the transaction are amortised on a proportional basis, keeping their relative size constant. This implies that the cost of protection remains broadly stable as a portion of the outstanding pool of exposures as well as of the income generated by the pool of exposures. The relationship between the cost of protection and the capital relief is also more stable under this scenario.

### Implications for SRT

88. From the prudential perspective of SRT, pro-rata amortisation schemes in the presence of back-loaded losses, i.e. losses that crystallise towards the end of the underlying exposures' tenor, may undermine the actual degree of risk transfer. Other things being equal, in the presence of pro-rata amortisation the originator is able to rely on a level of credit protection that, towards the end of the tenor of the transaction, is materially lower than the one it could rely on when a sequential amortisation scheme is adopted. For this reason pro-rata amortisation schemes represent a key structural characteristic to be assessed within the broader SRT assessment.
89. The contractual triggers of a switch to sequential amortisation observed in the market practice represent a partial safeguard against the possibility of impaired risk transfer. Whereas some conditions simply take a stance on the maximum level of cumulative net losses that can be incurred before the amortisation scheme reverts to sequential, other conditions focus on the relationship between the volume of non-matured defaults (hence the volume of potential losses) and the outstanding volume of available protection, triggering the switch to sequential amortisation when those two amounts become equal. The latter conditions try to ensure that sufficient protection remains available when potential losses, rather than realised losses, increase.
90. However, the above mentioned trigger conditions tend to be of back-ward looking nature, in that their definition relies on either realised losses or defaults to occur. Back-loaded losses, which represent the main impairment of SRT in the presence of pro-rata amortisation, may build-up even in the absence of losses or default events, where for instance the exposures of highest quality in the portfolio pre-pay and average credit quality of the portfolio starts deteriorating.

91. In order to take into account the risk of credit risk migration towards higher credit risk in a more forward-looking manner, before losses or defaults materialise, attention should also be given to changing PD and granularity parameters in the portfolio. In particular:
- a. An increasing weighted average PD of the portfolio may flag credit risk migration in the portfolio towards higher credit risk;
  - b. Even if weighted average PD remains constant, the concentration of underlying exposures within high-PD buckets, according to a bar-bell structure, may flag bar-bell credit risk migration in the portfolio;
  - c. Reduced granularity in the portfolio may be such that a limited number of defaults are sufficient to materially deplete or wipe-out the available protection.

#### Amortisation structure - proposals for discussion

92. *As a result of the reviewed market practices and range of supervisory practices in relation to amortisation structures, it appears appropriate to further specify that for the purposes of achieving SRT, pro-rata amortisation schemes within a securitisation transaction should be used in accordance with the following principles:*
- a. *Pro-rata amortisation should only be used in conjunction with clearly specified contractual triggers determining the switch of the amortisation scheme to a sequential priority, safeguarding the transaction from the possibility that credit enhancement is too quickly amortised as the credit quality of the transaction deteriorates, impairing the actual extent of risk transfer throughout the lifetime of the transaction. At least the following types of back-ward looking and forward-looking triggers should be featured in a SRT transaction:*
    - I. *Cumulative losses higher than [a given %] of the lifetime expected losses (EL) computed and disclosed by the originator, whereby lifetime EL equals the product of the regulatory 1-year EL on the underlying exposures and the weighted average life (WAL) of the transaction;*
    - II. *Cumulative non-matured defaults higher than [a given %] of the sum of the outstanding nominal amount of the protected tranche and the tranches that are subordinated to it;*
    - III. *Weighted average credit quality in the portfolio decreasing below a given pre-specified level and/or the concentration of exposures in high credit risk (PD) buckets increasing above a pre-specified level;*
    - IV. *Granularity of the portfolio falling below a given pre-specified level.*

*Whereas fixing regulatory percentages for the proposed triggers may be overly*



*simplistic, given the existing differences in securitisation structures as well as credit performance of different classes of underlying exposures, it should be responsibility of the competent authority to review that the trigger values proposed by the originator fully reflect the risk profile of the transaction under consideration.*

*The amortisation profile should be taken into account within the risk transfer self-assessment analysis submitted to the competent authority to support the SRT application (see the originator's quantitative self-assessment of risk transfer below), in particular covering a scenario where losses are back-ended, in accordance with loss distribution assumptions that are adequate to the class of exposures being securitised.*

### 3.2.3 Call options

#### Review of practices

##### Originator's call options

93. Different types of call options may entitle the originator to call the transaction ahead of the scheduled maturity as specific conditions (triggers) are verified.
94. Call options referred to in this section serve the broad purpose of allowing the originator to close the transaction when material changes of the transaction's characteristics have reduced or eliminated the economic benefit expected from the transaction at the origination date. In this respect, such call options are structural features used to tackle the economic efficiency of the transaction and differ from 'other early termination clauses', which normally relate to either the originator or the investor's bankruptcy or breaches of legal and/or contractual provisions. For that type of other early termination clauses see below in this chapter.
95. In traditional securitisations the originator can call the transaction by repurchasing the securitisation positions before all the underlying exposures have been repaid provided any such repurchase is exceptional and made at arm's length. In synthetic securitisations with embedded call options, the originator may terminate the credit protection agreement ahead of its scheduled maturity.
96. The most widely used originator's calls can be defined as follows:
  - a. Regulatory (and tax) call: they are only exercisable if there are changes in the legal, regulatory or taxation frameworks that have an impact on the content of the contractual relationship of the securitisation transaction or that affect the distribution of economic benefits derived from the securitisation transaction by any

of the parties in the transaction. In the market practice, the concept of regulatory call may have a wide scope to include, inter alia, changes in policy, changes in regulation, changes in authorities' interpretation of the regulation, as well as changes in accounting rules/standards or rating agencies' methodologies.

- b. Clean-up call: in accordance with the CRR for securitisations in respect of which the originator is seeking SRT these calls can only be exercised when 10% or less of the underlying exposures, in terms of original value, are yet to amortise. Furthermore, they must fully reflect the originator's discretion and they cannot be exercised to provide support to the transaction.
  - c. Time call: in certain transactions the originator is entitled to call the transaction at a given point in time, usually established with regard to the expected evolution of the economic efficiency attached to the transaction. The timing with which the call can be exercised varies, with the initial WAL of the portfolio often being used as the earliest admitted point in time for the call to be exercised.
  - d. SRT call: more recently, a limited number of transactions featured a call option according to which the originator is entitled to call the transaction after origination should the originator's competent authority decide that the transaction does not meet SRT requirements – at its first assessment of the transaction - or ceases to meet SRT requirements following the ongoing monitoring by the competent authority.
97. In specific cases, originator's call options have been coupled with **step-up clauses** related to the coupon payment on the tranches of traditional securitisations or the credit protection premiums paid in the context of synthetic transactions.

#### **Investor's options**

98. Most securitisation transactions only entitle investors to terminate the transaction in relation to specific events related to the originator's solvency or originator's compliance with legal and contractual provisions, rather than in relation to features of the transaction (as otherwise the SRT requirements with respect to repurchase of the exposures or securitisation positions specified in Art. 243(5)(d) and Art. 244(5)(e) would not be met). For this type of early termination clauses see below in this chapter.

#### **Implications for SRT**

99. The presence of certain originator's call options in securitisation transactions may prevent effective risk transfer from the originator to third parties. As observed during the financial crisis, particularly in bad times, originators may be incentivised to exercise the call options in order to support investors and/or maintain with their investor a positive business relationship. During the crisis several originators exercised call options as the performance

of the securitised portfolio deteriorated, effectively taking back on their balance sheet the risk that they were deemed to have transferred.

100. More generally, originator's call options may be included in the transaction to provide additional credit enhancement in favor of the investor, to support the investor or to otherwise avoid allocating to the investors losses that the investor should be absorbing.
101. Options exercisable by investors/protection providers, in circumstances other than contractual breaches or bankruptcy, may also undermine the effectiveness of risk transfer.

### Call options - proposals for discussion

102. *As a result of the reviewed market practices and range of supervisory practices in relation to call options, it appears appropriate to further specify that for the purposes of achieving SRT call options should be used in accordance with the following principles:*

a. *The definition of 'regulatory call option' should:*

- I. *Include changes in all relevant law and/or regulation (or official interpretation of that law and/or regulation by authorities) directly affecting the contractual relationship defining the transaction and/or materially affecting the allocation of benefits among the parties of the transaction. In this regard, relevant law/regulation includes relevant taxation and accounting provisions.*
- II. *Exclude other factors affecting the economic efficiency of the transaction that are not enshrined in law or regulation, such as credit rating agencies' methodologies or central institutions' collateral frameworks.*

b. *Time calls included in traditional securitisation transactions are expected to hinder SRT. This is already provided for in the EBA Guidelines (see Title III Paragraph 5(2)), whereby the only call options not expected to hinder SRT in the context of traditional transactions are listed to be (i) regulatory/tax call options and (ii) clean-up call options as defined in the CRR. For this reason the EBA Guidelines also provide that any traditional transaction with call options other than the ones explicitly admitted should be subject to the comprehensive assessment. In traditional transactions, in fact, time calls result in the right upon the originator to repurchase the securitised exposures. This right, as well as an obligation to re-assume the previously transferred risk, imply that the originator has maintained effective control over the securitised exposures in accordance with CRR Art. 243(5)(d), leading to the impairment of SRT.*

c. *As also specified in the EBA report on synthetic securitisation (see EBA 12/2015),*

*where a time call is included in a synthetic securitisation transaction, such call should in principle not be considered to hinder SRT if it can only be exercised at a point in time where the time elapsed since the securitisation's closing date is equal to or higher than the weighted average life (WAL) of the initial reference portfolio at closing. If the transaction features a replenishment period, a time period equal to the weighted average life (WAL) of the portfolio should elapse from the end of the replenishment period before the time call can be exercised. In any case, the time call should not be structured to avoid allocating losses to credit enhancement positions or other positions held by investors and should not be otherwise structured to provide credit enhancement.<sup>21</sup> This should be taken into account when the originators are constructing self-assessment or considering notifying the exercise of the call (see proposal on the notification of time calls in section 3.1.2). Time calls should be included within the risk transfer self-assessment analysis submitted to the competent authority to support the SRT application (see proposal on the originator's quantitative self-assessment of risk transfer below).*

- d. *As also specified in the EBA report on synthetic securitisation (see EBA 12/2015), early termination clauses linked to the outcome of the supervisory SRT assessment or to the withdrawal of the SRT status (i.e. SRT calls) should not be considered to hinder SRT.*

### 3.2.4 Excess spread

#### Review of practices

103. Whereas no standardised definition of excess spread exists in the market practice<sup>22</sup>, the CRR defines excess spread as the difference between the income collected on the securitised portfolio and costs and other expenses related to the transaction.
104. Not all securitisation transactions explicitly rely on excess spread within their payment waterfall. A broad distinction in this respect arises between, on the one hand, traditional securitisations, where securitised exposures are transferred (by legal or equitable assignment or other arrangement) to the SSPE and the excess spread is generated on the SSPE's balance sheet (which will be consolidated by the originating entity unless accounting requirements for de-consolidation are met), and, on the other hand, synthetic

<sup>21</sup> For example, the risks identified in section 3.2.1 in relation to the amortisation structure can be increased when asset amortisation is scheduled such that a significant portion of the portfolio is outstanding at the portfolio WAL. Given that pre-payments are more typical with better quality assets, the remaining portfolio balance at point of exercise of time call may have worsened in credit quality significantly.

<sup>22</sup> The Prime Collateralised Securities (PCS) true sale label criteria and risk transfer securitisation label criteria do not provide a standardised definition of excess spread.

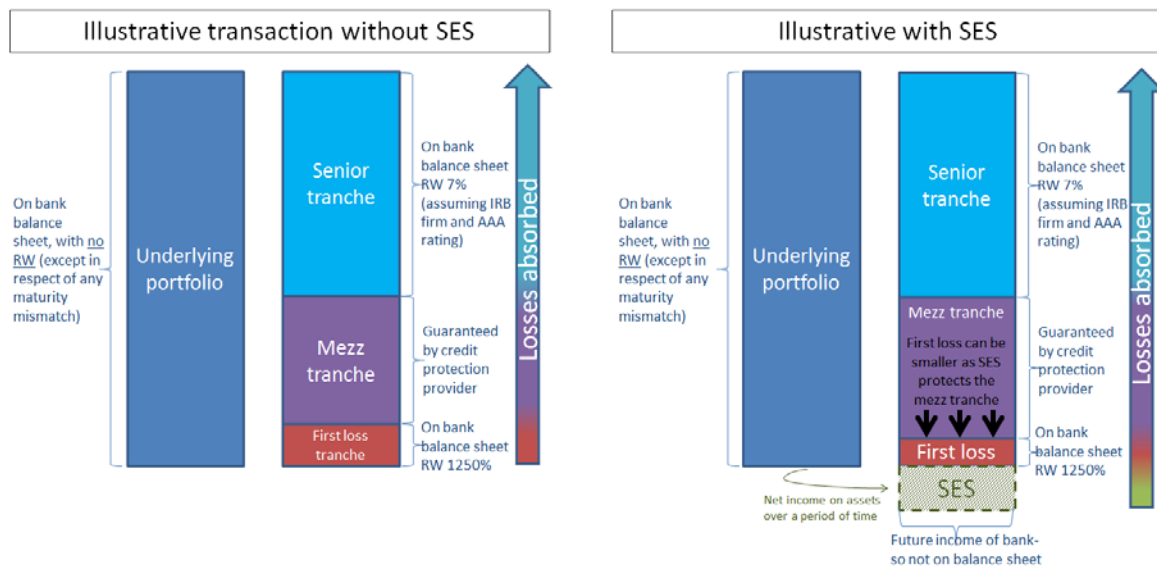
securitisations, where the excess spread is generated on the originator's balance sheet where the securitised exposures are being held.

105. In **traditional securitisation** the excess spread normally contributes to all interest and principal payments owed by the transaction in accordance with the contractual priority of payments. Remaining excess spread may be returned to the originator of the transaction as deferred consideration (either as profit i.e. net of portfolio losses or more senior in the capital structure), or to the investors in the first loss tranche.
106. In **synthetic securitisation** excess spread may be used as the most subordinated form of credit enhancement according to different practices, with regards to both its definition and allocation mechanism. With regard to the definition, the following main practices could be identified:
  - a. **Fixed excess spread:** the amount of excess spread that the originator commits to use as credit enhancement at each payment period is pre-determined in the contract, usually expressed as a fixed percentage of the total outstanding portfolio balance, e.g. 30 basis points of the outstanding portfolio balance. The excess spread is, under this scenario, a contractually committed credit enhancement buffer, within which losses will be absorbed before impacting any more senior position, and is therefore due to the lack of calculation of any excess amount no excess spread in the strict sense of the term;
  - b. **Variable excess spread:** mostly to replicate the functioning of a traditional securitisation transaction, excess spread is defined in a contract by means of formulae, resulting in a variable amount of excess spread at each payment period. Such formulae can be defined as the portfolio income that, at each payment period, exceeds the costs of the securitisation transaction, among others including the cost of credit protection, the spread paid on the senior tranche, or an equivalent funding cost whenever the senior tranche is retained by the originator, servicing costs and all other relevant costs.
107. Irrespective of the way the excess spread is defined, two main alternative allocation mechanisms are adopted in synthetic securitisation transactions:
  - a. **Use-it-or-lose-it mechanism:** during each payment period, excess spread may be used to cover credit losses materialising during that period. Excess spread not used for that purpose during the payment period is returned to the originator;
  - b. **'Trap' mechanism:** during each payment period, excess spread not consumed to cover losses materialising during that period is set aside to create a ledger (spread account) that cumulates over time and remains available to absorb losses when these materialise. Spread may cumulate in a ledger for the entire life of the transaction, it may alternatively start cumulating as a given performance trigger is

activated, from the date of a call option or may be cumulated to reach different target levels depending on agreed triggers.

108. Beyond the general practices described above, the allocation of excess spread may follow specific variants. Both traditional and synthetic securitisations can be structured to include a first loss tranche sold to investors that can amortise before more senior notes - in the absence of enforcement events - by using excess spread that is not required to cover losses in any given period (also known as *turboing* technique). Traditional securitisations can also be structured to achieve ongoing extraction of excess spread to the benefit of the originator via a specific class of notes that is retained by the originator and whose interest payments are paid *pari passu* to the most senior tranche's interest payments (e.g. so called Class X notes in CMBS transactions).
109. In some synthetic transactions variable excess spread may also be used to finance coupon payments to a first-loss category of investors rather than for directly covering losses. In these transactions the amount of excess spread to be used in this way may be capped to a pre-determined investor's internal rate of return: when such cap is reached, all payments funded by excess spread to the investors under consideration cease.
110. Lastly, transactions may also be structured to guarantee investors a pre-determined level of excess spread, which the originator may provide by entering into derivative (swap) transactions.
111. Some recognition of excess spread as credit enhancement by rating agencies allows originators to achieve better rating levels and/or to structure the transaction to include lower levels of traditional credit enhancement, i.e. to use relatively larger senior or mezzanine tranches and smaller first loss tranches. This, other things being equal, implies that excess spread increases the credit enhancement provided to investors and thus reduces the overall cost of the transaction, i.e. the coupon/credit protection fee that is due on the tranches placed with investors (as more subordinated tranches are more costly to remunerate on the market) and the regulatory capital cost of retaining tranches. Hereby the transaction's economic viability from an originator's perspective is enhanced (see below Figure 14).

Figure 14: The impact of synthetic excess spread (SES) on a transaction's structure



112. The degree of recognition of excess spread from a rating agency/investor perspective varies due to the contingent nature of the excess spread variable. Unless guaranteed by the originator at a pre-determined level, excess spread is future income that may or may not materialise as modelled/expected by the various parties depending on, inter alia, the following factors:

- a. Prepayments;
- b. Interest resets / exchange rates;
- c. Substitutions;
- d. Magnitude of delinquencies, defaults and losses.

113. Lastly, the actual degree of credit enhancement that the excess spread can offer crucially depends on the mechanism governing its allocation as well as the magnitude and timing of the losses. In the presence of high losses characterised by a back-loaded distribution, the use-it-or-lose-it mechanism may end up providing very little credit enhancement above and beyond the excess spread generated in a single period as, by the time the bulk of the losses materialise in the transaction, most of the excess spread generated by the transaction has been returned to the originator. By contrast, with back-loaded losses a trap mechanism may be such that excess spread cumulated during the life of the transaction is sufficient to cover losses as they materialise towards the end of the transaction's tenor.

### Implications for SRT

114. Both the Basel standards and the CRR do not recognise unrealised excess spread as a securitisation tranche, specifically for the calculation of attachment and detachment points

in the existing Supervisory Formula approach and for the future SEC-SA and SEC-IRBA. This implies that in computing own funds requirements for funded tranches and other securitisation positions, the respective attachment and detachment points cannot be modified to take into account unrealised excess spread.

115. The CRR is clear that as excess spread turns into realised income, and for the amount by which it is trapped into the securitisation structure to provide credit enhancement to more senior positions, excess spread is to be 1250% risk-weighted, in order to reflect its nature of income at risk and offset its recognition in the P & L account. The attachment and detachment points of the funded securitisation tranches and other securitisation positions change accordingly.
116. In this respect, from an originator's perspective, compared to funded first-loss tranches or other forms of funded first-loss credit enhancement, excess spread is less costly in terms of regulatory capital, i.e. it allows the transaction to achieve relatively higher RWEA savings. Also, depending on the supervisory assessment of SRT, excess spread may work as a device to retain risk that can go fully undetected by the SRT test and the SRT comprehensive assessment.
117. From a supervisory angle, the use of excess spread may imply that Pillar I own funds requirements do not fully reflect the risks retained by the originator and that the actual degree of risk transfer effected with the transaction is lower than the one the competent authority has assessed. An argument therefore generally exists that originators should recognise the use of excess spread as credit enhancement in their post-securitisation own funds requirements.
118. The above concerns on the use of excess spread apply equally to traditional and synthetic securitisation. However, whereas excess spread is a concern in traditional securitisation only in a limited number of circumstances, it leads to further complexities in synthetic securitisation transactions.
119. The use of excess spread in **traditional securitisation** does not generally pose material concerns in relation to SRT, unless, for instance, the originator enters into agreements whereby excess spread is in any form or shape a guaranteed amount to the investor. In certain transactions, a contractual agreement foresees that excess spread not eroded by losses is extracted from the transaction to the benefit of the originator, as deferred consideration. This is the case where, for instance, the securitised exposures are sold at par value despite their fair value is higher than par. Where such feature exists and the transaction does not achieve accounting de-recognition (potentially as a consequence of the excess spread mechanism itself), the extent of SRT may have to be assessed with particular focus.
120. In the case of **synthetic securitisation**, additional aspects related to the use of excess spread should be considered, as described in the points below:



- a. **Quantum of synthetic excess spread:** a too high amount of excess spread subordinated to the protection provider's position may be such that under no realistic scenario the protection provider's securitisation positions will be eroded by losses, resulting in no effective risk transfer. This could be the result of an inappropriate specification of excess spread within transactions that use actual excess spread (see below on the calculation of synthetic excess spread) or could occur in transactions that contractually commit a pre-determined amount of excess spread that is not proportionate to the level of risk that characterises the portfolio, e.g. as measured by the portfolios' expected loss amount, or cannot be generated by the portfolio (e.g. in case of yield-impaired portfolios).
- b. **Calculation of variable synthetic excess spread:** whereas in traditional transactions all income and expense/cost cash flows related to the transaction sit with the SSPE and may normally be determined in a self-contained manner in accordance with all the contractual conditions specified in the transaction documentation, in synthetic transactions the definition of relevant cash flows, in particular of expense/cost items, may be a more complex exercise. This is due to the fact that the originator keeps the securitised exposures on its balance sheet, remains the servicer of those exposures (no contractual servicing agreement is in place with any SSPE) and, in the vast majority of transactions observed, retains either the most senior securitisation tranche or both the most senior and the junior tranches. In particular, determining the funding costs related to those tranches, i.e. the remuneration that market investors would seek if those tranches were placed may be complex. Equally, disentangling other specific components of the cost/expense category such as servicing costs may be difficult. The discretion and complexity embedded in the specification of excess spread may result in materially different outcomes as regards the actual risk being transferred to third party investors.
121. Lastly, in both traditional and synthetic securitisation, for any given amount of excess spread that is generated by the portfolio, the chosen **allocation mechanism** may determine different outcomes in terms of effective credit enhancement provided to the transaction, depending on the size and volatility of the average credit losses. It can be shown that when expected losses are not evenly distributed across the life of the transaction and some degree of loss volatility is factored-in, no matter how the amount of available excess spread compares with the amount of expected losses, the trapped mechanism may provide higher effective credit enhancement than the use-it-or-lose-it mechanism. From the supervisory perspective of SRT, this means that when loss volatility is factored-in, the trapped allocation mechanism effectively counteracts SRT to a larger extent than the use-it-or-lose-it allocation mechanism.
122. Ultimately, the use of excess spread not duly reflected in the assessment of SRT may incentivize market participants, where allowed in accordance with the local approach, to move away from traditional funded credit enhancement (e.g. standard first-loss tranches)

and consistently rely on future margin income to provide first-loss credit enhancement, opening the way to the complexities as described in this Discussion Paper.

### Excess spread - proposals for discussion

123. *As a result of the reviewed market practices and range of supervisory practices in relation to the use of excess spread, it appears appropriate to further specify that for the purposes of achieving SRT:*

- a. *whenever excess spread is used in the context of a synthetic securitisation transaction providing first-loss credit enhancement:*
  - I. *The originator should commit to a fixed nominal amount of excess spread available in the transaction on a yearly basis to absorb losses on a first-loss basis;*
  - II. *The originator may only use the committed nominal amount on a yearly basis in accordance with a trapped mechanism (i.e. the amount of excess spread not absorbed by losses during a given year should remain trapped in the transaction in the form of a funded reserve account, available to absorb losses in future years);*
  - III. *The total (unfunded plus funded) excess spread amount committed on a yearly basis should be considered within the SRT tests as well as the test of commensurate risk transfer, as a securitisation position subject to 1250% risk weight/capital deduction;*
  - IV. *In order to ensure that originators do not commit amounts of excess spread that are excessive/can hardly be generated by the portfolio, it is proposed that the total (unfunded plus funded) committed amount every year may never be higher than the one-year regulatory EL on the underlying portfolio.*
- b. *When excess spread is used in a traditional securitisation transaction as a deferred interest of the originator providing first-loss credit enhancement to the transaction, the transaction should not commit more than the actual excess spread generated by the portfolio, i.e. the originator may not guarantee a fixed (i.e. pre-determined) level of excess spread;*
- c. *In any case, the transaction documentation should provide a definition of excess spread, including the breakdown composition of 'costs' and 'expenses' mentioned in Art. 242 point 1 of the CRR and the formulae used to compute the excess spread;*
- d. *The way in which the excess spread enters the waterfall should be clearly*

*represented;*

- e. *Excess spread should be taken into account within the risk transfer self-assessment analysis submitted to the competent authority to support the SRT application (see proposal on the originator's quantitative self-assessment of risk transfer below).*

### Further considerations for stakeholders' consultation on the use of excess spread

124. *The above proposals on the use of excess spread in securitisation transactions focus on the SRT implications of excess spread and aim at ensuring that such feature is used under sufficiently prudent conditions, particularly in the case of synthetic transactions, while being properly accounted for in the proposed quantitative methods to assess risk transfer.*
125. *As a broader prudential concern on the use of excess spread, this report highlights that, in line with specific Basel and CRR provisions of the current and new securitisation frameworks, future (i.e. unrealised/unfunded) excess spread may not be considered credit enhancement for the calculation of attachment and detachment points of a position in the existing Supervisory Formula approach and for the future SEC-SA and SEC-IRBA.*
126. *The EBA is currently assessing the merit of Pillar I own funds requirements on future excess spread used in synthetic securitisation transactions. In this context, the EBA is considering under which accounting and prudential provisions the credit enhancement represented by future excess spread may configure as a securitisation position and how the own funds requirements should be quantified, taking into account the uncertainty in terms of the amount of excess spread that will actually be available to a transaction in future periods.*
127. *The ongoing considerations on the accounting and prudential treatment of future excess spread do not question the clearly defined regulatory treatment of the realised/funded component (i.e. trapped component) of the excess spread commitment in synthetic securitisation transactions, that should in any case be subject to own funds requirements as any other positions providing funded first-loss credit enhancement, according to the provisions on the treatment of funded reserve accounts. The funded component (i.e. trapped component) of the excess spread commitment would in any case be subject to own funds requirements as any other positions providing funded first-loss credit enhancement, according to the provisions on the treatment of funded reserve accounts.*

### 3.2.5 Cost of protection

#### Review of practices

128. The cost of protection constitutes a fundamental structural element of the synthetic securitisation transaction.
129. From an originator's perspective, costs of protection are set with specific regard to the following factors:
- a. As credit protection is a substitute for the economic and regulatory capital that the originator will save by entering into the transaction (covering unexpected losses and expected losses not yet being considered in accounting in accordance with the applicable accounting framework), the originator looks at its cost of (target) capital as a benchmark;
  - b. The credit protection being agreed in relation to a specific reference portfolio, its costs will have to reflect the underlying credit risk, in terms of total expected losses being transferred to the investor (protection provider), in light of the historical default and loss performance of the portfolio and asset class under consideration;
  - c. With an outstanding market for synthetic securitisation transactions, the costs of protection may reflect current prevailing pricing conditions in a competitive environment, with originators in some cases selecting an investor's bid over several bids via a competitive/auction process.
130. The same factors impact on the investor's pricing condition, with the credit risk of the reference portfolio normally being the object of in-depth due diligence analysis. Furthermore, in funded credit protection agreements the investors also price-in the remuneration of the collateral they post in the transaction as well as the potential counterparty credit risk assumed on such collateral.
131. The market practice of credit protection agreements varies as to the way credit protection premium payments are formulated and scheduled. Broadly speaking, protection premiums may fall under one of the following categories:
- a. **Contingent premiums:** the actual amount of premium paid is a function of the size and risk of the protected tranche;
  - b. **Non-contingent premiums:** the actual amount of premium paid is not a function of the outstanding size and risk of the protected tranche.
132. Contingent premiums may be structured as a fixed percentage of the residual performing balance of the protected tranche at each payment date, hence reflecting tranche amortisation and tranche write-downs due to incurred losses. Non-contingent premiums may take the form of guaranteed premiums.

133. The timing of the premium payments may also vary across transactions. In some transactions protection premiums are paid up front, whereas in accordance with the most widespread market practice protection premiums are paid in accordance with a regular schedule. Transactions may also be structured to include protection premium rebate mechanisms, whereby if at the maturity of the protection period the aggregate premium paid by the protection buyer exceeds losses suffered on the reference portfolio, the excess would be returned to the originator.

### Implications for SRT

134. The Basel Committee issued two publications on the subject of high cost of credit protection, respectively in 2011 and 2013<sup>23</sup>. With respect to synthetic securitisations those publications reflect the supervisory concern that the cost of protection may in certain circumstances cast doubts on the effectiveness of risk transfer.

135. Supervisory concerns have focused on the following elements:

- a. **Guaranteed and other non-contingent premium structures:** agreements with guaranteed premiums, or other forms of non-contingent premiums effected via up-front payment structures or rebate mechanisms may be used to de-link the payments to the investors from those arising on the protected portfolio. Transactions were structured to ensure that premiums paid to the investor ultimately equal the amount of realised losses in the transaction, thus eliminating the risk to which investors are exposed. Such transaction structures essentially provide the originator with a way of controlling the timing of the losses rather than transferring any risk related to those losses (the originator 'pays' an amount equivalent to the realised losses via a regular stream of protection premiums, rather than absorbing those losses as they occur in the absence of a credit protection agreement). In such cases, the investor only incurs a nominal loss if the originator defaults on its premium payment obligations. Up front and rebate payment mechanisms, even when they are not structured to explicitly elicit risk transfer, may expose the originator to increased counterparty credit risk (vis-à-vis the protection provider), thus making the assessment of SRT more complex and potentially impairing effective SRT.
- b. **Quantum of the costs of protection:** more generally, the amount of credit protection premiums paid to the investor (potentially in conjunction with other fees and payments made to the investor) may be as high as to exceed the amounts of expected losses to be absorbed by investors under plausible scenarios. Transactions may be structured whereby the aggregate amount of premiums paid to the investor equals the notional value of the protected tranche, i.e. the maximum amount of losses that investors may absorb.

<sup>23</sup> BCBS Newsletter on high cost of credit protection (2011) and consultation document 'Recognising the cost of credit protection purchased' (2013).

- c. **Timing of the P&L recognition of the costs of protection:** while achieving an immediate regulatory capital relief, resulting from the SRT recognition and the consequent exclusion of the securitised exposures from risk-weighted exposure amounts, an originator may postpone the P&L recognition of, potentially very high, credit protection premiums it has committed to pay (i.e. equivalent to losses in P&L terms) as well as reduce the amount of provisions taken, if allowed to release provisions when taking into account the credit protection purchased. Overall, the originator may achieve a short-term regulatory capital outcome that is not reflective at all of the medium-term actual extent of risk transfer.
136. The CRR only specifies that the derivative or guarantee that is used to transfer risk should not include any contractual condition, which is outside the direct control of the lender, that may increase the effective cost of protection as a result of the deterioration in the credit quality of the protected exposures (Art. 231(1)(c)(ii)).
137. The EBA Guidelines have taken into account part of the concerns expressed by the Basel Committee and, in a nutshell, have specified that:
- a. whenever the credit protection premiums are not recognised in the originator's P&L, competent authorities should look at, among other factors:
    - I. How premiums paid compare to: (i) the income generated by the protected portfolio, (ii) the losses being covered by the protection, (iii) fair market rates, (iv) some combination of the factors mentioned at the previous points.
    - II. Whether other fees or payments beyond protection premiums are such that effective risk transfer in the transaction is undermined.
  - b. The competent authorities should also consider the impact of up-front premiums payment or other premium structures that avoid allocating losses to the protection provider.

### Cost of credit protection - proposals for discussion

138. *As a result of the reviewed market practices and range of supervisory practices in relation to the cost of protection in synthetic transactions, it appears appropriate to further specify that for the purposes of achieving SRT:*
- a. *Credit protection premiums should be structured as contingent premiums: no form of guaranteed premiums, upfront premium payments, rebate mechanisms or other mechanisms that may avoid allocating losses to the investor should be featured in the contract;*
  - b. *Credit protection premiums, jointly with excess spread used as credit enhancement*

*to the benefit of investors and other fees/payments to investors, should be taken into account within the risk transfer self-assessment analysis submitted to the competent authority to support the SRT application;*

- c. The documentation accompanying the SRT application should provide the competent authority with all relevant information that has been used to price the credit protection contract, including, as applicable, information on the market benchmarks and other market variables taken into account, by the originator, for the pricing and, as applicable, information related to the process of selection of the protection provider (investor).*

### 3.2.6 Other early termination clauses

#### Review of practices

139. Early termination events can be linked to certain originator's rights to call the transaction when material changes in the transaction's characteristics have reduced or eliminated the economic benefit expected from the transaction at the origination date.
140. Beyond the early termination linked to the cost efficiency of the transaction, other early termination clauses serve the purpose of terminating the transaction whenever specific events occur in relation to one of the parties in the transaction. In particular the following events are generally used to trigger early termination:
- a. Failure to pay;
  - b. Breach of a material contractual obligation;
  - c. Illegality arising from a contractual obligation;
  - d. Originator's (/protection provider's) bankruptcy (examinership, insolvency, moratorium or similar proceedings) (synthetic securitisation only).

#### Implications for SRT

141. With the exception of the originator's bankruptcy, the other early termination clauses discussed in this chapter do not pose concerns in relation to SRT.
142. The originator's bankruptcy as a clause of early termination in synthetic transactions is reported as widespread market practice of the synthetic securitisation market in the EBA Report on Synthetic Securitisation (2015). That report discusses this termination clause from a twofold perspective:

- a. **Investor (protection provider) perspective:** the originator's bankruptcy exposes the investor to the following risks: (i) subordination vis-à-vis other creditors of the insolvent originator, (ii) deterioration of the originator's servicing standards/incentives during the bankruptcy phase. The early termination clause allows investors to mitigate these risks as the originator's bankruptcy occurs, thus maintaining an incentive for the protection provider to participate in such market;
- b. **Originator (protection buyer) perspective:** in case of termination of the credit protection contract in a scenario of originator's bankruptcy, the originator's insolvency estate may not rely on credit protection on the securitised portfolio and is faced with reduced regulatory capital resources against the portfolio under consideration due to the previous achievement of SRT and consequent capital relief since origination. In this respect the recovery prospects of the originator's other insolvency creditors are at stake as the credit protection contract is terminated upon the event of bankruptcy and the question arises, whether the achievement of SRT and the resulting capital relief can be deemed adequate from a prudential perspective for transactions including such early termination event.
143. It is however also to be noted that with the introduction of the BRRD, as an alternative to liquidation, originators may be subject to resolution measures. The BRRD foresees that, as originators enter resolution, structured finance transactions and other specific classes of arrangements are subject to specific provisions safeguarding the transactions' counterparties, in the context of partial property transfers and other resolution measures. In these cases contractual clauses such as termination upon originator's bankruptcy may be dis-applied and the rights and interests of the counterparties in the transaction would be dealt with by BRRD-specific measures and tools<sup>24</sup>.

### Other early termination events – proposals for discussion

144. *With the exception of the originator's bankruptcy, none of the other early termination clauses discussed in this report (i.e. failure to pay, breach of a material contractual obligation, illegality arising from a contractual obligation) appear to undermine or in any way reduce the extent of SRT.*
145. *The EBA is currently assessing the regulatory treatment of the originator's bankruptcy as an early termination clause in synthetic securitisation transactions, in order to strike the right balance between the two perspectives from which such provision is to be considered.*

<sup>24</sup> It should be noted that a number of (small) firms are likely to be excluded from such BRRD provisions.



### 3.2.7 Credit events (synthetic securitisation only)

#### Review of practices

146. As discussed in the EBA Report on Synthetic Securitisation (2015), credit events are those events that trigger credit protection payments from the protection seller to the protection buyer within a credit protection contract. Typical credit events include:

- a. Failure to pay after 90 days (i.e. 90 days past-due);
- b. Restructuring of the reference credit/obligor;
- c. Bankruptcy of the reference credit/obligor.

#### Implications for SRT

147. The definition of credit events affects the likelihood of credit protection payments occurring and, consequently, determines different extents of protection for the originator and of risk transfer towards investors.

148. Other things being equal, including in the contract credit events that are more likely to occur favors the protection buyer, as the latter can expect to receive more credit protection payments. By contrast, including credit events that are less likely to occur is a favorable choice from the protection seller's perspective, as protection payments are less likely to take place. Depending on how credit protection payments are determined and scheduled, including credit events that are, by definition, more likely to occur, can imply an increased need for more adjustment payments, i.e. late payments carried out at the end of the loss work-out period in cases where the initial payments made at the time of the credit event do not correctly reflect the severity of the credit event. Potentially, this implies that the originator may be exposed to an increased extent of counterparty credit risk that may put at risk effective SRT.

149. The definitions of credit events provided in the CRR shape the way prudential regulation quantifies the risk to be covered by regulatory capital. For the regulatory approach to credit risk to be adequately reflected in the credit protection agreement of synthetic securitisations it is important to ensure that the definitions of credit events included in the contract are, at a minimum, aligned with those provided for in the CRR.

150. The parties in the contract may agree on additional events or stricter definitions of the events mentioned in the criterion (e.g. failure to pay with a grace period of less than 90 days), in line with the general framework provided for in the standard industry master agreements, as long as the credit protection agreement complies with the requirements provided for in Part Three, Title II, Chapter 4 of the CRR and, at a minimum, the events taken into account for prudential purposes are included in the credit protection agreements.

### Credit events – proposals for discussion

151. *As a result of the reviewed market practices and range of supervisory practices, it appears appropriate to further specify that for the purposes of achieving SRT, synthetic securitisation transactions should at least foresee the following credit events:*

- a. *Failure to pay, defined to encompass at a minimum the circumstances defined in Article 178 (1)(b) of the CRR;*
- b. *Bankruptcy, defined to encompass at a minimum the circumstances defined in Article 178 (3)(e) and (f) of the CRR;*
- c. *Restructuring, defined to encompass at a minimum the circumstances defined in Article 178(3) (d) of the CRR.*

### 3.2.8 Credit protection payments and loss calculation

#### Review of practices

152. The processes applied for loss calculation and protection payments upon occurrence of the credit event may also vary from institution to institution. The loss calculation normally reflects the actual or realised loss on the securitised exposure that gave rise to the credit event. Some transactions allow for interim payments/settlements, based on an estimated loss (in a timeframe usually up to three months following the credit events). This is then followed by the final adjusted payment at the end of the work out process, which in certain cases could take up to three years.

#### Implications for SRT

153. In the EBA Report on Synthetic Securitisation (2015), the EBA indicated that credit protection payments should be calculated on the basis of the actual work-out of the losses as carried out by the originator in accordance with its ordinary work-out and recovery policy.

154. Within the same report the EBA indicated that an interim credit protection payment, at the latest one year after the credit event was reported, is a desirable feature from the perspective of the originator's capital position, given that the full work out of the losses can be a lengthy process and in order to ensure a minimum degree of timeliness in credit protection payments in all circumstances.

155. These elements of the credit protection contract constitute best practice, in the view of the EBA, from the perspective of the originator's capital position throughout the life of the

transaction. The quality of the credit protection contract is an important element that competent authorities look at when assessing SRT.

### 3.2.9 Replenishment and substitution of assets

#### Review of practices

156. While some securitisations have a static pool of exposures which does not change during the lifetime of the securitisation apart from the amortisation of securitisation exposures, many securitisation transactions allow the originator to replenish the securitised portfolio by adding additional exposures to the pool, as the portfolio is depleted as a result of amortisation, prepayment, repayment or removal of an obligation from the asset portfolio after the occurrence of default. The replenishment is indeed a common feature of securitisation transactions, as it allows the originator to maximise its drivers for the transaction, whether capital relief, funding or otherwise.
157. In addition to replenishment, many transactions allow substitution of assets which are no longer compliant with the asset eligibility criteria. Replenishment and substitution are usually subject to strict pre-defined conditions so as to ensure the continued quality of the portfolio. Replenishment and substitutions are often not allowed throughout the entire term of the transaction, but only for a limited period (usually three to five years).
158. In the EBA report on synthetic securitisation (2015), the EBA recommended (in criterion 2 for qualifying treatment of synthetic securitisation) the following:

#### Box 2: EBA report on synthetic securitisation (2015): criterion on substitution and replenishment conditions

*The securitised exposures should at all times be subject to predetermined and clearly defined criteria determining their eligibility for protection under the credit protection agreement. Exposures added to the securitisation after the closing should meet eligibility criteria that are no less strict than those applied when structuring the securitisation. After the closing date the securitisation should not be characterised by an active portfolio management on a discretionary basis including the sale of exposures being protected under the credit protection agreement. Substitution of exposures that are in breach of eligibility criteria or replenishment criteria should in principle not be considered as active portfolio management.*

159. In the EBA report on qualifying securitisation, the EBA also recommended (in criterion 10), with respect to the transaction documentation of those transactions featuring a pool of revolving exposures, the following:

#### Box 3: EBA report on qualifying securitisation (2014): criterion on replenishment and substitution triggers

*The transaction documentation of those transactions featuring a pool of revolving exposures should include the following triggers to prevent the acquisition of additional exposures:*

- a) the occurrence of an insolvency-related event with regards to the originator as well as the servicer;*
- b) a deterioration in the credit quality of the underlying exposures to or below a pre-determined threshold;*
- c) the unavailability of exposures that meet the pre-determined credit quality;*

*The transaction documentation of such transactions should also include the following triggers to provide for early amortisation of the securitisation positions, in order of seniority:*

- a) the occurrence of an insolvency-related event with regards to the originator as well as the servicer.*
- b) a deterioration in the credit quality of the underlying exposures to or below a pre-determined threshold;*

*c) the fall in the value of the underlying exposures held by the securitisation below a required threshold.*

160. The above triggers have been developed as part of conditions for a qualifying treatment of traditional securitisation transactions (see Box 3) and some specific balance sheet synthetic securitisation transactions (see Box 2), and with the underlying objective to provide a protection to the investors. Given their relevance also for the SRT discussion, the EBA considers that these triggers should generally be taken into account by the originators when designing an SRT transaction.

### Implications for SRT

161. The criteria identified by the EBA in, respectively, the EBA report on qualifying securitisation (2014) and the EBA report on synthetic securitisation (2015) constitute best contractual practice and contribute to identify high quality transactions. In the context of the SRT assessment competent authorities look at replenishment and substitution contractual conditions, to make sure the originator does not indirectly support the investor and/or avoids allocating to the investors the losses that the credit protection arrangement is meant to transfer.

#### **3.2.10 Originator's quantitative self-assessment of risk transfer: stress-test analysis on risk transfer accompanying the SRT application**

162. The previous sections of this chapter have indicated further specifications of the SRT requirements that should facilitate the comprehensive assessment of transactions by competent authorities and, at the same time, ensure that any given structural feature is looked at with a similar supervisory approach across Member States in the Union. Further regulatory/supervisory clarity on those aspects is expected to improve the common understanding of market participants as to how transactions should be structured to increase the likelihood of a positive outcome of the SRT comprehensive assessment by the competent authority.

163. The role played by each of the discussed structural features, and their interaction in the context of the transaction, may however vary on a case-by-case basis, requiring an adequate bespoke analysis. For the competent authority to carry out such analysis, it appears essential in the first place to request from the originator a quantitative self-assessment of risk transfer, aimed at proving to the competent authority a deep understanding as to how the most important structural features interact in the context of the transaction, under well-specified plausible scenarios, and at providing a quantitative representation of the risk transferred to third party investors over the lifetime of the transaction and the portfolio.

164. The complexity of this self-assessment, in terms of scenarios analysed and methodology, should be proportionate to the complexity of the transaction, given that the transaction

may embed one or several structural features. It is however expected that, as a minimum via a cash flow model, base-case and stress scenarios are represented to measure the lifetime risk transfer effected by the transaction, as measured by the comparison between, on the one hand, the losses absorbed by third party investors in the transaction and, on the other hand, both the average RWEA saving arising from the securitisation transaction and the losses absorbed by third party investors as a % of total losses in the transaction and the portfolio.

**Proposal for discussion on the originator's quantitative self-assessment of risk transfer: stress-test analysis on risk transfer accompanying the SRT application**

165. *As a result of the reviewed market practices and range of supervisory practices, it appears appropriate to further specify that for the purposes of achieving SRT, the originator should submit to the competent authority a quantitative self-assessment of risk transfer. This assessment should provide evidence as to how total losses absorbed by third party investors as a % of total losses in the transaction and the portfolio over the lifetime of the transaction compare to:*
- a. *The average reduction of RWEAs incurred by the originator post-securitisation;*
  - b. *The total losses expected to arise over the lifetime of the transaction.*
166. *The quantitative assessment should, as applicable depending on the structural features embedded in the transaction, include at the least the following elements:*
- a. *A base case and a stress scenario of PD and LGD parameters attached to the underlying exposures;*
  - b. *A base case and a stress scenario regarding the timing of the realisation of the losses, whereby the stress scenario should represent a back-loaded distribution of portfolio losses;*
  - c. *A base case and a stress scenario regarding the portfolio's behaviour in terms of pre-payments;*
  - d. *The applicable amortisation structure, including the sequential amortisation triggers if the amortisation structure is different from the sequential one;*
  - e. *A base case and a stress scenario regarding the availability of excess spread, if excess spread is used in the transaction as credit enhancement;*
  - f. *The stream of credit protection premiums and credit protection payments (if the transaction is of the synthetic type);*
  - g. *Any time call (only admissible for synthetic transactions);*

167. *The quantitative assessment should be carried out on the basis of the transaction's cash-flow model. Depending on the complexity of the transaction under consideration, the quantitative assessment may also be carried out using Monte Carlo simulations.*
168. *The stress scenarios should refer to the portfolio stress scenarios implemented by the institution in the context of the latest EU-wide stress tests, where relevant and available.*
169. *In any case, in the context of this exercise, the originator should provide the CA with the cash flow model used for the quantitative self-assessment of risk transfer.*

**Question 7: Do you agree with the assessment of the SRT implications of all the identified structural features? Are any material aspects missing from this representation?**

**Question 8: Do you agree with the proposed safeguards related to the use of pro-rata amortisation?**

**Question 9: Do you agree with the proposed safeguards related to the use of time calls? Do you agree with the different approach to time calls in traditional vs. synthetic transactions?**

**Question 10: Do you agree with the proposed safeguards on the use of excess spread in traditional securitisation?**

**Question 11: Do you agree with the proposed safeguards constraining the use of excess spread in synthetic securitisation? In particular, do you agree with:**

- a. **The proposal of only allowing a contractually fixed (pre-determined) excess spread commitment in synthetic transactions?**
- b. **The proposal to only allow a 'trap' excess spread allocation mechanism in synthetic transactions?**

**Question 12: Do you agree with the proposed way to treat the excess spread commitment in synthetic securitisation transactions for the purposes of the quantitative assessment of SRT and commensurate risk transfer?**

**Question 13: In relation to the further considerations for stakeholders' consultation on the own funds treatment of excess spread:**

- a) **Do you agree that the unrealised/unfunded component of the excess spread commitment should become subject to Pillar I own funds requirements?**

**b) What would be the impact on SRT transactions if Pillar I own funds requirements were recognised as suggested in Section 3.2?**

**Question 14: Are there any other safeguards or alternative regulatory treatments to address risks retained through excess spread in traditional and synthetic securitisation transactions?**

**Question 15: Should there be a specific treatment in those transactions featuring excess spread in which the originator, instead of achieving SRT in accordance with one of the SRT tests specified in the CRR, chooses to deduct all retained securitisation positions from CET 1 or apply a risk weight of 1250% to all of such securitisation positions ('full deduction option'), in order to be allowed to exclude the securitised exposures from the calculation of risk-weighted exposure amounts?**

**Question 16: What are your views on the use of originator's bankruptcy as an early termination clause? How does this clause interact with the resolution regime (i.e. the BBRD framework)? Should this clause be banned?**

**Question 17: Do you agree with the proposed originator's self-assessment of risk transfer? Should such assessment be formulated differently?**

**Question 18: Are you aware of circumstances where institutions have entered into a structured risk transfer transaction which is not captured by Articles 243 or 244 CRR? For example, where the accounting treatment has meant a transaction is not considered for SRT assessment, or where transactions economically similar to SRT transactions do not fall into the definition of a 'traditional securitisation' or 'synthetic securitisation'.**

### 3.3 Assessment and suggested options with respect to quantitative SRT tests

#### 3.3.1 Assessment of the quantitative SRT tests

##### Underlying rationale of the quantitative SRT tests

###### *Focus on measuring the significance of the risk transferred*

170. As a general principle, the quantitative SRT tests foreseen in the CRR (the first loss test and the mezzanine test) focus on measuring the ‘significance’ of the amount of risk transferred to third parties by means of comparison of post-securitisation own funds requirements, i.e. a comparison of the own funds requirements for securitisation positions retained by the originator and the own funds requirements for securitisation positions transferred to third parties on the relevant tranches.
171. Whereas in addition to these quantitative SRT tests focussing on the significance of the risk transfer, the CRR also envisages the concept of ‘commensurateness’ of the risk transferred, with respect to the reduction in risk-weighted exposure amounts (for the transactions subject to the quantitative SRT tests) or the reduction of own funds requirements (for the permission-based transactions) achieved as a result of the securitisation. Such concept includes, in other words, a comparison of the risk-weighted exposure amounts or own funds requirements of the originator pre- and post-securitisation. Commensurateness of risk transferred does not enter any hard-wired test in the CRR, nor is it defined by means of any objective benchmark threshold; it is however a criterion the competent authorities may use to prevent securitisation transactions from achieving SRT, on a case-by-case basis, following an assessment of the transaction. Given the lack of a standardised threshold, practices differ both among the competent authorities as well as among the institutions on how to test the commensurate risk transfer.

###### *Reflection of underlying expected loss (EL) and unexpected loss (UL) assumptions of the credit risk framework*

172. The tests build on an underlying assumption of the CRR credit risk framework, according to which the EL of an exposure is generally to be covered by any credit risk adjustments applied to the exposure in accordance with the applicable accounting framework, whereas the UL of that exposure is covered by the own funds requirements for credit risk<sup>25</sup>. Both of the current quantitative SRT tests apply this general assumption as a basis (although they

<sup>25</sup> In order to cover the UL completely, the own funds requirements for credit risk for a particular exposure have to correspond to the current exposure value of such exposure after considering specific credit risk adjustments on the exposure. Instead, the CRR requires institutions to hold own funds against an UL amount that is according to a certain confidence level not being exceeded within the relevant time horizon of one year.



differ in terms of the way how a significant transfer of the UL is measured and in terms of other assumptions underlying the tests).

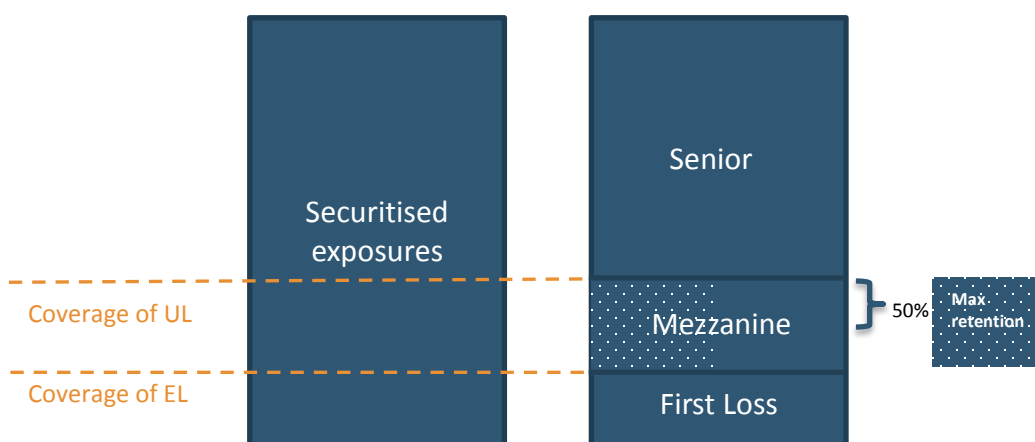
#### *Underlying assumptions of the mezzanine test*

173. The mezzanine test (both in the current as well as in the new CRR) is based on the following assumptions:

- a. the first loss tranche of a securitisation with mezzanine securitisation positions covers mainly or exclusively the EL on the securitised exposures;
- b. the mezzanine securitisation positions cover mainly or exclusively the UL on the securitised exposures.

174. Taking these assumptions into account, the mezzanine test is focused on UL amounts, and it intends to ensure that originator transfers at least 50% of the UL on the securitised exposures to third parties. It is considered irrelevant for the result of the mezzanine test, whether the first loss securitisation positions subject to a 1250% risk weight/CET1 deduction are transferred to third parties or retained by the originator.

Figure 15: Rationale of the mezzanine SRT test (test pursuant to point (a) of CRR 243(2) and 244(2))

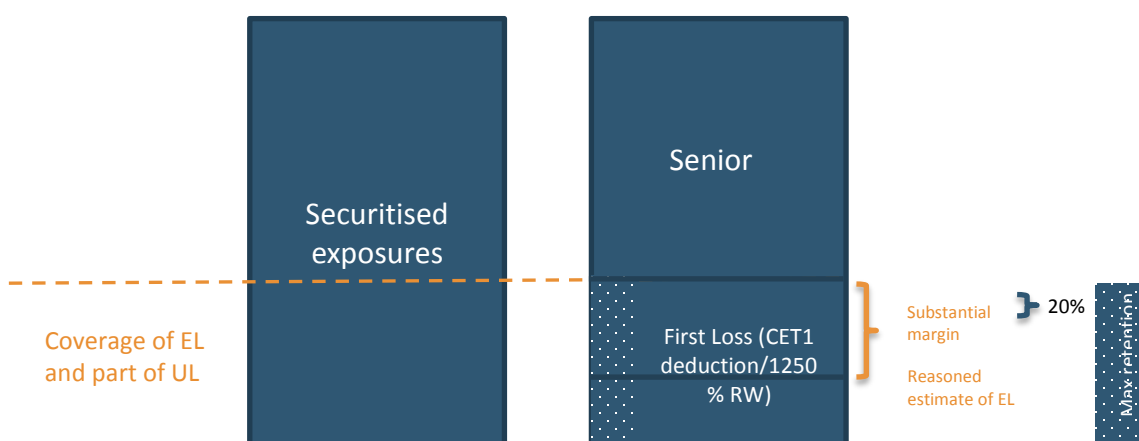


#### *Underlying assumptions of the first loss test*

175. The first loss test is based on the assumption that where no mezzanine securitisation positions exist, the thickness of the first loss securitisation positions subject to CET1 deduction/1250% risk weight is sufficient to cover not only the EL on the underlying exposures, but also a major share of the UL on the underlying exposures. This is reflected in the CRR requirement that the exposure value of such securitisation positions should exceed a reasoned estimate of the expected loss on the underlying exposures by a substantial margin. Ultimately, this is grounded on the expectation that the most senior tranche of the securitisation structure is exposed to a minor share of the UL (or is fully insulated from the UL).

176. Taking this assumption into account, the first loss test requires a major share of the securitisation positions that are subject to CET1 deduction/1250% risk weight to be transferred to third parties, in order to ensure a transfer of a significant part of the UL, consistently with the spirit of the mezzanine test.
177. While the mezzanine test is indifferent with regard to the retention or transfer to third parties of securitisation positions mainly or exclusively covering the EL -- given potential losses on these tranches are already completely anticipated through the CET1 deduction/application of 1250% risk weight if they are retained, and given the transfer of UL is targeted through mezzanine positions -- this does not hold for the first loss test. Instead, due to the *pari passu* allocation of the actual losses to holders of the securitisation positions that are subject to CET1 deduction/1250% risk weight (irrespective of whether these losses relate to the EL or UL), the first loss test may effectively require the originator to transfer also parts of the EL, depending on the specific structure of the transaction and, in particular, on which portion of the UL is actually covered by the positions subject to CET1 deduction/1250% risk weight.
178. In order to achieve a comparable extent of transfer of UL as achieved under the mezzanine test, and taking into account that part but not all of the UL may be covered by positions subject to CET1 deduction/1250% risk weight, the first loss test imposes a higher threshold for the risk transfer than the mezzanine test (80% vs. 50%).
179. The first loss test in the new CRR equally builds on this assumption, with the difference that it refers to first loss positions instead of positions subject to CET1 deduction/1250% risk weights.

Figure 16: Rationale of the first loss SRT test (text pursuant to point (b) of CRR 243(2) and 244(2))



### Limitations of the current quantitative SRT tests

180. The quantitative SRT tests provide a simple and standardised metric to assess whether a significant share of the UL (in case of mezzanine test) and also a significant share of the EL (in case of first loss test) has been transferred to third parties, using post-securitisation own funds requirements on relevant tranches as a measure for the significant transfer of credit risk. The tests have been assessed by competent authorities as providing an adequate formula for assessment of the significance of the risk transferred. While a number of limitations has been identified - some relating to both tests others to either of the two tests - the overall assessment of the identified deficiencies does not indicate a need for a comprehensive reform of the current framework, but rather for some targeted amendments.
181. Following is the assessment of the specific limitations that the EBA identified with respect to both current tests as well as future tests in the amended CRR, also taking into account the feedback received from the market participants through the questionnaire on SRT.
182. As a general point, it should be noted that while the CRR quantitative SRT tests generally allow for a consistent SRT treatment of securitisations across institutions and competent authorities, this does not hold for all cases. A common disadvantage of using simple and standardised tests is that they can naturally not be deemed suitable for covering all potential structures of securitisations in an equally appropriate manner.

#### *No clear safeguards against the use of relevant tranches with insufficient thickness*

183. The CRR tests are grounded on supervisory assumptions as to the allocation of credit risk losses on the underlying exposures across the securitisation structure, which may not be consistent with the actual allocation of EL and UL. Both first loss and mezzanine tests implicitly rely on the assumption that the thickness of the tranches subject to the tests is sufficient to cover the corresponding share of EL (first loss test) and UL (mezzanine test) of the securitised exposures. The tests do not include clear safeguards to ensure that securitisations with relevant tranches that are too thin to cover the corresponding share of EL and UL may not pass the tests, and hence are open to possible regulatory arbitrage.
184. The mezzanine test does not include any such explicit safeguard to ensure a minimum thickness of the relevant tranche. The first loss test does make a reference to the thickness of the relevant tranche, however the reference appears too vague. The first loss test requires that the exposure value of the relevant securitisation positions should exceed a 'reasoned estimate' of the expected loss on the underlying exposures by a 'substantial margin'; however no further guidance is provided on how a 'reasoned estimate' of the expected loss should be derived (e.g. whether to consider 1-year EL or EL for lifetime of transaction; how to calculate EL for securitisation positions treated under the Standardised Approach), and what can be considered as a 'substantial margin' in this regard.

*No additional requirement to assess the sustainability of the SRT*

185. The requirements of the tests have to be fulfilled on an ongoing basis as long as the originator intends to exclude the securitised exposures from the calculation of RWEA and to use the securitisation framework. The current quantitative SRT tests do not require to consider – as part of the initial SRT assessment - whether the requirements are likely to be met throughout the lifetime of the transaction or any other longer-term period (e.g. a period corresponding to the weighted average life of the securitised exposures subject to a cap of 5 years). This deficiency of the tests contrasts with the supervisory objective and expectation that SRT is achieved on a sustainable basis, in order to avoid a substantial volatility of capital ratios caused by SRT transactions. Given the lack of a standardised regulatory approach, competent authorities as well as market participants use different approaches to assess the thickness of relevant tranches (see annexes for the overview of supervisory and market practices respectively, in this matter).
186. The quantitative SRT tests provide for a point in time assessment of the significance of the credit risk transfer to third parties but do not explicitly consider the impact of the expected development of securitised exposures and securitisation positions on the SRT over the maturity of a transaction. From a regulatory perspective, any SRT achieved should be sustainable based on the information available at the closing of the transaction, in order to avoid the use of SRT transactions for the mere short-term optimisation of capital ratios for individual reporting dates, which would introduce significant volatility in the originator's capital ratios.

*Limited focus on the commensurateness of the transferred risk*

187. The quantitative SRT tests are generally based on a comparison of the post-securitisation own funds requirements of securitisation positions held by the originators and held by third parties on the relevant tranches. By contrast, the assessment of commensurate transfer of credit risk relies on a comparison of the transfer of credit risk to third parties with the possible reduction in risk-weighted exposure amounts (Art. 243/244(2)) or the reduction of own funds requirements (Art. 243/244(4)) an originator would achieve, i.e. the commensurate transfer of credit risk test also includes a comparison of the risk-weighted exposure amounts or own funds requirements of the originator pre- and post-securitisation. Unlike for the significant risk transfer, the CRR however does not include any standardised test for determining the commensurateness of the risk transferred from a quantitative perspective. The new CRR explicitly requires the EBA to review the interpretation by competent authorities of the commensurateness of the transferred risk.

*Specific limitations of the mezzanine test*

188. A few additional limitations have been identified concerning the mezzanine test, stemming from the existing definition of the mezzanine tranche and the mezzanine test in the current CRR. The new CRR addresses these limitations.

189. First, the identification of mezzanine tranche in the current CRR is contingent on the existence of a rated tranche (in those cases where securitisations include more than two tranches treated with a risk weight below 1250%).<sup>26</sup> This approach does not appear to be in line with the general policy objective to reduce reliance on external ratings in regulation. Such reliance on credit assessments of ECAs indicates that mezzanine securitisation positions may not be determined in case of securitisations including more than two tranches treated with a risk weight below 1250% where no external credit assessments of an ECAI exists for the respective tranches. It consequently also indicates that the mezzanine test could not be used for such securitisations, where the risk weights of the originator's securitisation positions are determined based on the Supervisory Formula Method.<sup>27</sup> It is to be noted that the amendments to the CRR address this issue, as the new definition of the mezzanine position is no longer dependent on the existence of an external rating.
190. The current wording of the quantitative tests also leads to an inconsistent treatment of two tranche securitisation transactions. In case of two tranche transactions where neither of the tranches is assigned a risk weight of 1250%, the mezzanine test is applicable and hence up to 50% of the relevant tranche may be retained by the originator (with no requirement in terms of tranche thickness). Instead, in a two-tranche transaction where one tranche is treated with a risk weight of 1250%, the first loss test applies in which case only up to 20% of the relevant tranche may be retained by the originator (under the additional condition that the exposure value of the securitisation positions assigned to the respective tranche exceeds a reasoned estimate of the EL on the underlying exposures by a substantial margin). Again, the new CRR addresses this inconsistency, as it makes clear that the mezzanine test is only applicable to three tranche structures (as according to the new definition of the mezzanine tranche it must be a tranche that is more senior than the first loss tranche and subordinated to the senior tranche). Hence, all two tranche securitisations are thus subject to the first loss test.

#### *Specific limitations of the first loss test*

191. As already mentioned above, the CRR does not provide any further guidance on the interpretation of the terms 'substantial margin above a reasoned estimate of the expected loss' on which the test is based -- neither for securitisation positions under the IRB Approach, nor for securitisation positions under the Standardised Approach. While the CRR provides a definition of EL for the purposes of the credit risk framework (Art. 5 point (3) of CRR), no conditions are provided for what is considered a reasoned estimate of the EL for

<sup>26</sup> It is assumed that such an external rating is not necessary in the case of a securitisation transaction composed of only two tranches with a risk weight below 1250%, as the combination of the 'below 1250% risk weight' requirement and the 'more junior than the most senior position' requirement is sufficient to determine which securitisation positions qualify as a mezzanine securitisation position.

<sup>27</sup> In this regard, evidence from EBA analysis indicates that supervisory practices in terms of the interpretation of the definition of the mezzanine tranche in Art. 243(3) and 244(3) CRR are currently not consistent. While some competent authorities require external credit assessments on all securitisation positions including mezzanine tranches, other competent authorities allow originators to rely on the mezzanine test even in the absence of an external rating on the mezzanine tranche, and still some other competent authorities require an external rating only on the transferred mezzanine tranche.

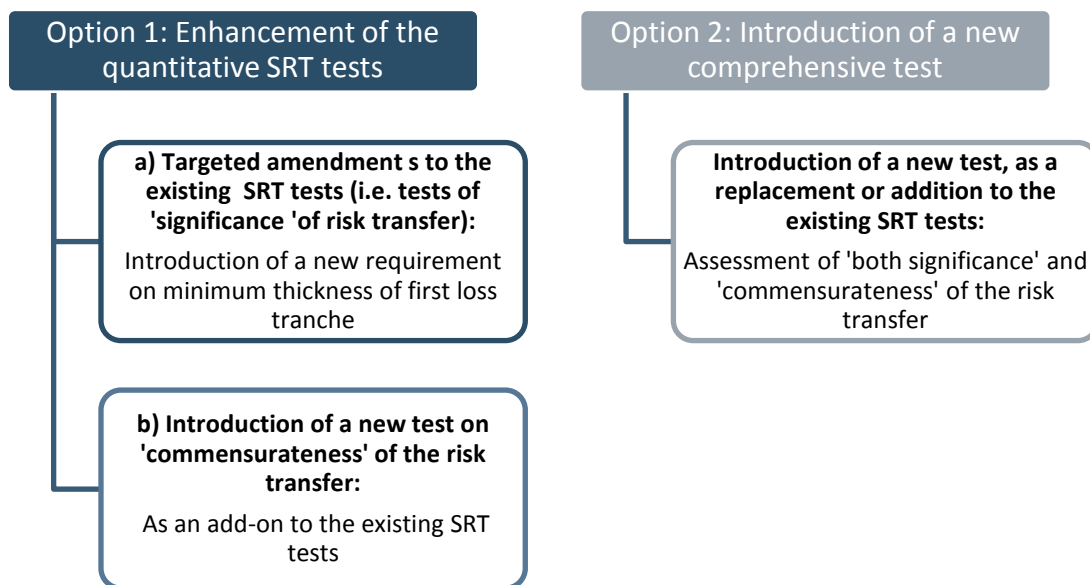
the purposes of the securitisation framework. It is also not clear what approach should be taken in case where the securitised exposures are mainly exposures for which the originator cannot calculate the EL (pursuant to the IRB requirements of Art. 158 CRR). The legal uncertainty resulting from the insufficient specification of these terms is also inconsistent with the underlying objective to provide a simple and standardised test for measuring the significance of the credit risk transfer.

### 3.3.2 Options suggested by EBA

192. The current quantitative SRT tests are well established in the securitisation market and the available information does not indicate a need for fundamental changes to these tests. The options suggested by EBA are therefore focused on proposing targeted amendments to the applicable framework, rather than on establishing a fundamentally new framework.
193. The proposals issued for discussion have been designed to address the following objectives:
  - a. They should enhance consistency of SRT tests by providing a simple, harmonised and standardised framework that would reduce the scope for differing interpretations by competent authorities and originators;
  - b. They should be compatible with the future EU securitisation framework, on which they are focused;
  - c. They should fix and address the identified deficiencies of the tests.
194. As regards the last point, the proposals under consideration should address in particular the following limitations of the existing tests:
  - a. They should standardise the requirements for the assessment of commensurateness of the transferred risk: while it is clear that any assessment of the commensurateness of the credit risk transfer will not exclusively rely on quantitative considerations but also on qualitative ones, which should take into account structural features of the transaction and the securitised exposures, the EBA proposals should incorporate an additional harmonised quantitative formula to support the assessment of the commensurateness of a securitisation's credit risk transfer. Review of interpretation of the commensurateness is also explicitly required in the regulatory mandate assigned to the EBA in the new CRR;
  - b. They should enhance the sustainability of the SRT: the EBA proposals should include requirements to consider the achievement of SRT in the longer term in order to reflect the regulatory objective that SRT should be sustainable to avoid an increased volatility of capital ratios caused by SRT transactions;

- c. They should provide safeguards against the use of relevant tranches with insufficient thickness: this should prevent cases of possible regulatory arbitrage where the requirements of the tests are passed without effective transfer of a significant amount of risk.
195. When considering these proposals, it should be taken into account that as the current tests are targeting securitisations with different general structures and a large variety of specific structural features, certain inconsistencies between simple and standardised quantitative tests may remain and no combination of tests will ensure a similar treatment of all securitisations in terms of the SRT assessment. It is however important to limit such inconsistencies and ensure that the quantitative tests lead to similar results for a vast majority of securitisations. All remaining cases should be addressed within the competent authorities' discretion to decide that significant transfer of credit risk has not been transferred to third parties due to a lack of commensurate transfer of credit risk (in accordance with Art. 243(2) or 244(2) second subparagraph).
196. As regards the full deduction option i.e. use of CET1 deduction/1250% risk weights on all retained tranches in a securitisation (as per CRR Art. 243/244(1)(b)), the EBA considers that when this option is applied instead of the SRT test, this does not necessarily generate prudential concerns, as long as the additional requirements pursuant to Article 243(5) or 244(5) CRR are fulfilled and the transaction does not include certain structural features without minimum safeguards as contemplated in this Discussion Paper. However, the EBA notes that this option is not equivalent and hence comparable with transferring of significant and commensurate risk away from the originator. It should also be taken into account that neither the competent authorities nor the EBA are currently being notified of the use of this option, and hence have no information on its actual application in practice including compliance with the requirements pursuant to Article 243(5) or 244(5) CRR.
197. Taking into account the above considerations, two alternative proposals are suggested with respect to the quantitative SRT tests, summarised in the Figure 17 below as well as at the end of this chapter.

Figure 17: Options proposed by EBA with respect to the quantitative SRT tests



198. Option 1 builds on the assumption that no changes to the current level 1 text are envisaged and deemed required in the short term, beyond the changes that will enter into force in the context of the new EU securitisation framework (introducing only minor changes to the existing tests). Option 1 is therefore focused on introducing targeted amendments to these applicable tests (it is recommended that the amendments are implemented by means of binding technical standard/delegated act).
199. As an alternative to the proposals above, and with a view to further streamline the SRT-test framework in the medium/long term, it could be envisaged to introduce an inherently new SRT test, as presented in Option 2. This test could potentially replace or be introduced as an addition to the applicable SRT tests.
200. The purpose of the proposed changes is to achieve more regulatory certainty but also a strengthened quantitative SRT framework and a facilitated comprehensive assessment of the transaction for competent authorities. The approach should not replace the comprehensive SRT assessment, but should rather enhance a common approach to consideration of significance and commensurateness of the transferred risk.

### Option 1: Enhancement of the quantitative SRT tests

201. As part of the Option 1, the EBA proposes to introduce two specific changes to the quantitative tests:
- a. First, to insert a new requirement in both existing SRT tests (i.e. both first loss and mezzanine tests, focused on assessing 'significance' of the risk transfer), on a minimum thickness of the first loss tranche. No additional changes are proposed by



the EBA to the conditions of the SRT tests (such as, for example, to the amount of risk that is required to be transferred for the purpose of passing the tests);

- b. Second, to introduce a new additional test addressing the ‘commensurateness’ of the risk transfer.

202. In line with the proposals in the Section 3.2, excess spread should be considered in all of the above tests, as a retained position, subject to 1250% risk weights/capital deduction.

(i) *Introduction of a supplementary requirement for a minimum thickness of the first loss tranche*

203. As explained in the section outlining the limitations of the existing SRT tests, the CRR does not define a minimum thickness of the relevant tranches that are used to demonstrate the SRT, as a condition to pass the tests. Guidance is provided in this respect in the EBA Guidelines (point c of paragraph 3.1), which require to conduct a comprehensive assessment for a securitisation if a particular information indicates that the thickness of tranches which are used to demonstrate SRT may not be sufficient to assume a commensurate risk transfer to third parties with regard to the special credit risk profile and the corresponding RWEA of the securitised exposures of the securitisation. A comprehensive assessment is also required according to the EBA Guidelines when the losses incurred on the securitised exposures in previous periods or other information indicate that:

- a. an institution’s reasoned estimate of the expected loss on the securitised exposures until the maturity of the transaction may be too low to consider significant credit risk as having been transferred to third parties. The total maturity of the transaction should be taken into account, including the potential existence of excess spread;
- b. the margin by which the securitisation positions that would be subject to CET1 deduction/1 250% risk weights exceed the reasoned estimate of the expected loss until the maturity of the transaction may be too low to consider significant credit risk as having been transferred to third parties.

204. In order to ensure that the tranches subject to the tests are sufficiently thick to cover the corresponding shares of EL and UL, the EBA proposes to define a minimum thickness of the first loss tranche, which would be applicable to both securitisation transactions subject to the first loss test, as well as transactions subject to the mezzanine test. The requirement should be based on the following formula:

**Requirement for transactions subject to first loss test:**

*Nominal value of first loss tranche + Lifetime excess spread*  
 $\geq \text{Lifetime EL} + \frac{2}{3} \text{ of Regulatory UL}$

**Requirement for transactions subject to mezzanine test (i.e. transactions including mezzanine tranche):**

*Nominal value of the first loss tranche + Lifetime excess spread*  $\geq$  *Lifetime EL*

**Additional clarifications:**

Lifetime EL (under SEC-IRBA):

*Lifetime EL = 1 year EL × WAL of securitised exposures*

Lifetime EL (under SEC-ERBA and SEC-SA):

*Lifetime EL = (Impaired loans × 0.5) × WAL of securitised exposures*

Lifetime excess spread:

*Lifetime excess spread = Total excess spread amount*  
*committed on a yearly basis × WAL of securitised exposures*

Where: for the purposes of the tests proposed in this chapter *WAL is capped at 5 years*

205. The EBA proposes that for the purpose of the **first loss test**, the nominal value of the respective first loss tranches should at least cover the sum of lifetime EL and two thirds of the regulatory UL. This requirement would ensure that the first loss tranche is sufficiently robust to cover the EL and a major share of the UL, 80% of exposure value of which needs to be transferred to third parties.
206. When SEC-IRBA is used for calculation of own funds requirements for securitisation positions, the lifetime EL should reflect the expected loss on the securitised exposures for the weighted average life (WAL) of such securitised exposures, and should be calculated as a 1 year EL multiplied by the WAL, where: (i) EL is calculated in accordance with the CRR<sup>28</sup>; and (ii) WAL is capped at 5 years in accordance with the general maturity treatment in the CRR.
207. In case of use of SEC-ERBA and SEC-SA, it is proposed that the EL estimate computed as a rate of underlying loans in default ('w')<sup>29</sup> multiplied by 0.5, is used as a proxy to 1-year expected loss (0.5 reflects an implicit LGD of 50%).
208. The EBA proposes that for the purpose of the **mezzanine test**, the nominal value of the first loss tranche in the transactions involving mezzanine positions, should at least cover the lifetime EL (while the lifetime EL should be calculated in accordance with the previous two paragraphs). This requirement aims to prevent structuring transactions with very thin first loss tranches, where the mezzanine tranche attaches below the lifetime EL and does not cover a sufficient amount of UL. Transferring 50% of the RWEA of the mezzanine tranche

<sup>28</sup> Article 158 of the current CRR

<sup>29</sup> During the first year of the transaction, an estimation of the rate of impairment based on historical data of the asset class should be considered as the minimum value of 'w'.

would in this case allow to pass the mezzanine test, however it would not lead to an effective transfer of a sufficient amount of UL of the securitised portfolio.

209. On the one hand, originators may be dis-incentivised to structure a three-tranche transaction with very thin first loss tranche given the impact on the economic efficiency of such transaction. On the other hand, structuring such transactions will be made simpler under the new formulae-based approaches for calculation of capital for securitisation positions. Introduction of a requirement on the minimum thickness of the first loss tranche would therefore limit the possibility of regulatory arbitrage.
210. The EBA does not propose to introduce a requirement on the minimum thickness of the mezzanine tranche. It is assumed that this will be addressed through a new definition of the mezzanine tranche in the new EU securitisation framework (which requires that all tranches risk weighted above 25% and below 1250% are considered mezzanine positions for the purpose of SRT tests), in interaction with the new approaches for calculation of own funds requirements (which increase the non-neutrality of required capital for the securitisation positions).
211. As regards the excess spread, it is proposed that this feature should be appropriately reflected in the SRT tests. Consistently with the proposals in the Section 3.2.2, the securitisation position resulting from the excess spread committed to the transaction for a (weighted average) life of the transaction, should be recognised as a retained first loss securitisation position subject to 1250% risk weights/capital deduction. In this sense, when excess spread exists in a transaction, the amount of such excess spread committed to the WAL of transaction, should be allowed to contribute to the minimum thickness of the first loss tranche (and thus facilitate compliance with the requirement on the minimum thickness).
212. On the other hand, as regards the first loss test, inclusion of the excess spread in the thickness of the first loss tranche effectively makes the first loss test more difficult to pass, as the excess spread is considered a retained 1250% risk weighted position, and more risk would need to be passed onto third parties to meet the test. This requirement does not have a direct impact on the mezzanine test.

*(ii) Introduction of a new test of commensurateness of the risk transfer*

213. It is proposed that a new test is introduced, as an add-on to the existing SRT (first loss and mezzanine) tests, in order to harmonise the assessment of commensurateness of the transferred risk. The test is based on the following formula:

**Commensurateness risk transfer test:**

$$\frac{\text{Ratio 1:}}{\text{(capital pre sec including EL) - (capital post sec. on retained pos.)}} \leq \frac{\text{Ratio 2:}}{\text{(Lifetime EL + reg. UL on transferred pos.)}} \\ \text{(capital pre sec including EL)} \leq \text{(Lifetime EL + reg. UL of the underlying portfolio)}$$

**Ratio 1:**

- (i) the difference between the own funds requirements pre-securitisation on the whole underlying portfolio calculated according to the general credit risk framework including EL on the one hand, and the own funds requirements post-securitisation calculated in accordance with the securitisation framework corresponding to all credit risk retained by the originator on the other hand; and
- (ii) the own funds requirements pre-securitisation on the whole underlying portfolio calculated according to the general credit risk framework including EL.

**Ratio 2:**

- (i) the lifetime EL + regulatory UL of the underlying portfolio allocated to securitisation positions transferred to third parties (this calculation should take into account the lifetime excess spread that is considered as a retained position); and
- (ii) the lifetime EL + regulatory UL of the whole underlying portfolio.

214. Essentially, this test assumes that the transfer of risk is considered as commensurate when the ratio of capital reduction achieved by the originator (measured in the Ratio 1) is equal to or lower than the ratio of risk transferred to third parties (measured in the Ratio 2).
215. **Ratio 1** considers the savings in terms of own funds requirements achieved by the originator through a securitisation. First, it looks at the own funds requirements on the underlying portfolio pre-securitisation, calculated according to the general credit risk framework ( $K_A$  or  $K_{IRB}$ , computed according to the new securitisation framework). Second, it looks at the own funds requirements on the retained positions in the securitisation, calculated in line with the securitisation framework. For the sake of clarity, excess spread is not considered in the own funds requirements on the retained positions since it is not currently subject to any capital requirement.
216. **Ratio 2** measures the risk transferred to the third parties, for the (weighted average) life of the transaction. It essentially sums the amount of the lifetime EL and regulatory UL on all the positions that have been transferred to third parties. This amount is adjusted to take into account the amount of excess spread committed by the originator, for the lifetime of the transaction. Given the excess spread is effectively a retained securitisation position, it decreases the amount of the risk transferred, in the calculation of the numerator of the Ratio 2 (and thus in the end makes the test more difficult to pass).
217. Since the own funds requirements applicable to securitisation positions under all available approaches for calculation of securitisation capital captures both expected and unexpected losses, the own funds requirements on the underlying portfolio pre-securitisation considered in the Ratio 1 should also include expected losses charged on underlying assets. The EL should be calculated over a 1-year horizon, in line with the 1-year approach to credit risk measurement under the credit risk framework.

218. On the other hand, for the purpose of Ratio 2, lifetime EL should be considered instead of one-year EL calculated for the weighted average life (WAL) of the securitised exposures. This reflects a conservative approach to measure the commensurateness of the risk transfer, aimed to ensure that the reduction in RWEA achieved by the originator reflects the share of losses transferred to third parties for the life of the transaction.
219. By making the calculation of the share of the losses dependent on the assessment of lifetime EL, and explicitly considering the impact of the expected development of securitised exposures and securitisation positions on the SRT over the maturity of a transaction, the test -- in addition to addressing the commensurateness of the risk transfer -- also addresses sustainability of the risk transfer.
220. Similarly as in the previous section, when SEC-IRBA is used for calculation of own funds requirements for the securitisation positions, the lifetime EL should reflect the expected loss on the securitised exposures for the weighted average life (WAL) of such securitised exposures, and should be calculated as a 1 year EL multiplied by the WAL, where: (i) EL is calculated in accordance with the CRR<sup>30</sup>; and (ii) WAL is capped at 5 years in accordance with the general maturity treatment in the CRR. In case of use of SEC-ERBA and SEC-SA, it is proposed that the EL estimate computed as a rate of underlying loans in default ('w')<sup>31</sup> multiplied by 0.5, is used as a proxy to 1-year expected loss (0.5 reflects an implicit LGD of 50%).

### Option 2: Introduction of a new comprehensive test

221. As an alternative to Option 1 above, and with a view to further streamline the SRT-test framework in the medium/long term, it could be envisaged to introduce an inherently new SRT test, to supplement or potentially replace the existing SRT tests.
222. The test is based on a simple and standardised formula addressing both significance and commensurateness of the risk transferred. As it is however not focused on assessing the sustainability of the SRT in the first place, it could also possibly be complemented by the test specified in the Option 1 above.

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<sup>30</sup> Article 158 of the current CRR

<sup>31</sup> During the first year of the transaction, an estimation of the rate of impairment based on historical data of the asset class should be considered as the minimum value of 'w'.

223. The test is based on the following formula:

**New comprehensive test:**

2 conditions need to be met:

Condition 1:

*Own funds req. on retained positions + 1 year excess spread  
 $\leq (EL + 50\% UL)$  on the underlying exposures*

Condition 2 (only applicable when SEC-ERBA is used):

*95% of the positions attaching below  $K_A$  and which are neither 1250% risk weighted nor deducted from CET1 must be transferred to third parties*

224. **Condition 1** of the proposed test essentially requires that the own funds requirements on the securitisation positions retained by the originator (including one year excess spread committed to the transaction) do not exceed 1-year EL plus a pre-defined quantum of the own funds requirements for the UL on the securitised exposures the originator would have to hold if the exposures had not been securitised.
225. The 50% threshold is applied only to the UL share given that, both post-securitisation and pre-securitisation, one to one capital and provisions, respectively, are set aside to cover the EL share. The value of the threshold is equivalent with the policy objective that at least 50% of the UL should be transferred to third parties in order for the credit risk transfer to be considered significant and commensurate. Unlike the current SRT tests that explicitly require the transfer of a certain share of the mezzanine positions (mezzanine test) or of the first loss tranche (first loss tests), the proposed test allows the originator to retain any combination of securitisation positions so as to meet the condition 1.
226. According to the **condition 2**, which is only applicable when the transaction is assessed under SEC-ERBA at least 95% of all securitisations positions which fulfil the following conditions, have to be sold or transferred to third parties: (i) the securitisation positions attach below  $K_A$ , as applicable; and (ii) the securitisation positions are neither subject to a 1250% risk weight nor deducted from CET 1.
227. Condition 2 is a prudential requirement that ensures that the SRT test remains appropriately rigorous in situations where securitisation positions which would normally be subject to a 1250% risk weights or deducted from CET 1 under the formula-based approaches (SEC-IRBA or SEC-SA) are instead subject to risk weights which may be too low comparatively to their risk. Such a situation arises in the case of the external ratings based approach (SEC-ERBA), where the own funds requirements for securitisation positions in certain tranches relies on external ratings and are not directly related to the own funds requirements on the underlying assets.
228. Methodologies used by ECAs to derive the external ratings (for example, due to recognition of excess spread) may in fact lead to a decrease in the non-neutrality of the own funds requirements for securitisations. This can result in a situation where the

originator can meet the condition 1 while retaining most of the riskiest tranches, which would normally have to be transferred. This additional backstop in the condition 2 therefore reinforces comparability across the external ratings based and formula based approaches that are used by originators to determine own funds requirements on the retained securitisation positions.

229. 95%, instead of 100% of such tranches are required to be sold, to prevent that the test interferes with the minimum risk retention requirements, which require that originators must retain exposure to a minimum of 5% of the risk of the underlying assets on an ongoing basis.
230. When a transaction incorporates excess spread, the 1-year amount of excess spread should be considered in the test as a retained tranche subject to a 1250% risk weight/CET1 deduction.
231. The test aims to address in a comprehensive manner certain inconsistencies between the two SRT tests of the existing framework, reduce the risk of potential regulatory arbitrage and enhance consistency of the SRT assessment. The test incorporates both the aspect of measuring significance as well as commensurateness of the risk transferred. This is essentially due to the fact that it imposes a policy objective of reducing the retained risk below a pre-defined threshold, and at the same time it links the required amount of risk transferred through the securitisation with the risk on the underlying securitised assets. The test addresses the concerns with respect to the insufficient thickness of the tranches, as the formula does not allow to meet the test by transferring a thin tranche, also given the non-neutrality of the securitisation framework. The test also decreases the reliance on the external ratings, as ratings are not required for the application of the test. The test is generally more severe compared to the existing quantitative tests and, unlike the additional test of commensurateness proposed under option 1, only provides for a point in time assessment but not for a sustainable assessment of the commensurateness of the risk transfer to third parties.
232. A few case studies are provided in the Annex 4 to demonstrate the application of the new tests proposed under Option 1 and Option 2 on individual transactions.

### 3.3.3 EBA proposals for discussion for enhancing the quantitative tests

233. *As a result of the reviewed market practices and range of supervisory practices, in order to address certain identified limitations of the existing quantitative SRT tests and respond to the mandate included in the new CRR on further specifying the concept of commensurate risk transfer, it appears appropriate to gather stakeholders' views on two options to complement (Option 1) or complement/potentially modify (Option 2) the new CRR SRT framework.*

234. **Under Option 1, it is proposed that the existing two SRT tests are supplemented with:**

- a. *Introducing targeted amendments to the existing SRT tests (the current tests being focused on assessment of significance of the risk transfer), by introducing a minimum requirement on the thickness of the first loss tranche to both first loss and mezzanine tests;*
- b. *Introducing a new test – as an addition to the existing SRT tests above - to standardise the quantitative assessment of commensurateness of the risk transferred. This test should be based on a quantitative formula requiring that the percentage savings in own funds requirements that the originator achieves from the pre- to the post-securitisation scenario should be equal to or lower than the percentage of total losses transferred to investors (where losses are measured as the sum of lifetime EL and regulatory UL).*

235. **Under Option 2, it is proposed that the existing two SRT tests could be supplemented, or potentially replaced, with a new comprehensive test:**

- a. *Such test would impose that the risk retained by the originator (as measured by post-securitisation own funds requirements) be equal or lower than the sum of EL and a given percentage (50%) of the UL on the securitised portfolio, irrespective of the type of tranches the originator decides to use to transfer credit risk.*
- b. *In order to achieve a more consistent treatment of rated transactions for which the risk weights of the corresponding securitisation positions are determined in accordance with the SEC-ERBA and unrated transactions (subject to SEC-IRBA or SEC-SA), the test would also require that the originator sells at least 95% of the positions that, despite covering part of the underlying credit risk (i.e. attaching below  $K_A$ ), are not 1250% risk-weighted/deducted from the capital. Given that these positions will typically exist in rated transactions subject to SEC-ERBA, this requirement is only applicable when the SEC-ERBA is used.*

236. **Excess spread** should be taken into account in these tests under both Options 1 and 2 and should be considered as a retained first loss position subject to a 1250% risk weight/deduction from CET 1.

237. **Proposal for discussion with respect to the full deduction option:** It is proposed to introduce a requirement for the originator to notify the competent authority of each case of application of the full deduction option to a specific transaction. The competent authority should inform the EBA of all the notified transactions, on an annual basis.



- Question 19:** Do you agree with the proposed specification of the minimum first loss tranche thickness for the purpose of the first loss test?
- Question 20:** Do you agree with the proposed specification of the minimum first loss thickness for the transactions assessed under the mezzanine test (i.e. transactions including mezzanine securitisation positions)? Do you consider this requirement relevant for all the approaches for calculation of securitisation own funds requirements (including e.g. SEC-ERBA)?
- Question 21:** Is a specification needed of the minimum thickness of tranches constituting mezzanine securitisation positions for the purpose of the mezzanine test?
- Question 22:** What impact do you expect the new CRR securitisation framework to have on tranches' minimum thickness?
- Question 23:** Do you have any comments on the test of commensurate risk transfer proposed under Option 1?
- Question 24:** Do you have any comments on the test of SRT and commensurate risk transfer proposed under Option 2? In particular, is the 50% threshold for SRT therein needed and appropriate?
- Question 25:** Should the SRT test be different depending on asset classes? Should it differ across STS and non-STS transactions?
- Question 26:** Could you provide, on the basis of SRT transactions that are part of your securitisation business, an assessment of the impact in terms of SRT achievement of the proposed requirements under both Option 1 and Option 2, taking into account the new EU securitisation framework (Securitisation Regulation package)?

## 4. The regulatory treatment of NPL securitisation

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*This chapter seeks stakeholders' views on the SRT treatment of NPL securitisation, on the basis of the new EU securitisation framework (i.e. the CRR as revised by the newly proposed Securitisation Regulation reform package), with a two-fold objective: (i) assessing the workability of the SRT framework proposed in this Discussion Paper in light of the specificities of NPL securitisation transactions; and (ii) understanding whether any element of the regulatory framework applicable to NPL securitisation may pose unintended hurdles to the well-functioning of the market for NPL securitisations, which represent a viable route for EU institutions to tackle the issue of NPL resolution.*

*The calculation of pre- and post-securitisation own funds requirements is a necessary step of the SRT assessment. In light of the new EU securitisation framework, the EBA clarifies that the non-refundable purchase price discount that characterises NPL securitisation transactions should be treated as credit enhancement within the calculation of securitisation tranche capital when applying the newly introduced formulae-based approaches to own funds requirements (i.e. SEC-IRBA and SEC-SA), implementing a 'gross book value approach' to the assessment of risk in securitisations of NPL portfolios.*

*The EBA is also aware that, given the specific provisions of the CRR credit risk framework on the measurement of expected and unexpected losses on defaulted exposures, as well as the presence of a purchase price discount, the significant risk transfer and commensurate risk transfer tests envisaged in this Discussion Paper may not be fully functional in the case of NPL securitisations. Furthermore, the EBA recommendations on the SRT treatment of specific transaction structural features may also have to be tailored to the case of NPL transactions. Specific stakeholders' feedback is sought as to whether and how the proposals included in this consultation should be modified to cater for the specific aspects of NPL securitisation transactions, or whether different ad-hoc approaches should be envisaged for the case of NPL transactions.*

*NPL securitisation is one of the viable routes for the EU banking sector to tackle the resolution of the currently high levels of NPLs. In the context of the ongoing European discussion on the resolution of NPLs, this chapter frames the regulatory aspects of NPL securitisation within a broader presentation of the NPL securitisation market practice, as observed in the post-crisis period. The EBA intends to gather stakeholders' views on the broader aspect of the relationship between the regulatory framework and the functioning of the NPL securitisation market.*

## 4.1 NPL securitisation: market activity

238. The stock of non-performing loans remains one of the most important hurdles to the well-functioning of institution lending across several jurisdictions in Europe, as well as a drag on institutions' profitability that, in certain cases, becomes a threat to their viability. The policy debate in the European Union on how to facilitate and promote the resolution of NPLs and institutions' balance sheet cleaning has involved, to date, several European bodies.
239. The EBA (2016) published a report on NPLs in the European Union, quantifying the extent of the problem and identifying several impediments to the timely and efficient resolution of the NPL problem. The European Commission (2017) launched a consultation on the development of secondary markets for non-performing loans, mandating the EBA to introduce due diligence data and disclosure templates aimed at facilitating the functioning of NPLs' secondary markets. The Council of the European Union (2017) published an action plan on the resolution of NPLs, backed by a technical report, calling for action and reform in the areas of institution supervision, national insolvency frameworks, a secondary market for NPLs and a restructuring of the banking industry. The ESRB (2017) published a report that provides policymakers with general guidance with respect to the steps that need to be taken to design the overall response to the NPL issue.
240. The process of NPLs transfer can follow different routes and involve different tools. The EBA (2017), among others, called for the creation of a European Asset Management Company or, alternatively, a European blueprint for National Asset Management Companies to further kick-start the NPL market activity.
241. Securitisation as a means of disposing of NPLs was already used in the European Union prior to the latest financial crisis, with the first transactions being launched back in 1999. Available market research indicates that approximately EUR 15 billion of NPL securitisation tranches were issued prior to the crisis, mostly during the period 1999-2003.
242. Issuance of NPL securitisations, in the post-crisis period, took the form of both private/bilateral and public transactions. Available data on issued NPL securitisations is summarised in Figure 18 below. NPL securitisation only took place in 2016 and 2017.
243. At the time of writing, three additional public NPL transactions are announced in Italy<sup>32</sup> for 2017, for a total value of approximately EUR 6.3 billion, as follows: (i) 2017 announced NPL transaction by Monte dei Paschi di Siena, as part of the lender's precautionary recapitalisation approved by the European Commission in July 2017<sup>33</sup>; (ii) 2017 announced

<sup>32</sup> Other transactions have been realized on bilateral basis and no detailed information are available at the time of writing.

<sup>33</sup> Gross book value EUR 26.1 billion: A1 note (senior) for EUR 3.526 billion (12.5% of GBV), A2 note (senior) for EUR 0.5 billion (1.9% of GBV), Mezzanine note for EUR 1.029 billion (4% of GBV) and Junior note for EUR 0.686 billion (2.6% of GBV).

NPL transaction by Banca Carige<sup>34</sup>; (iii) 2017 announced NPL transaction by Credito Valtellinese<sup>35</sup>. All three transactions are expected to benefit from the Italian senior guarantee GACS scheme (see section 4.2.3 on the GACS scheme). In addition, the Italian institution Unicredit publicly announced the plan to securitise a portfolio of NPLs of gross book value of EUR 16.2 billion, although the volume of the securitisation issuance and the related purchase price discount have not yet been announced.

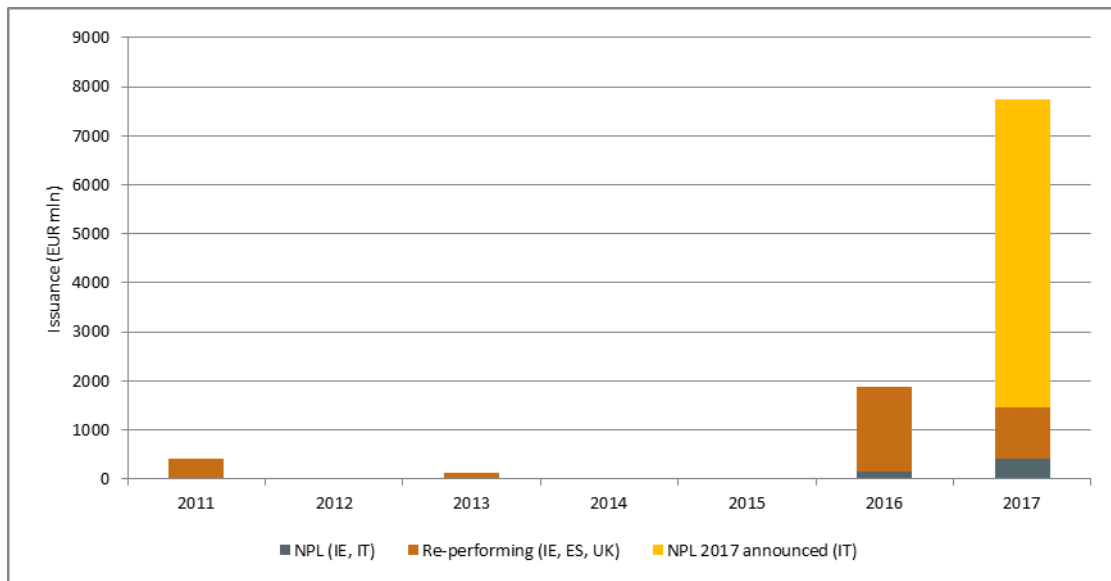
244. The vast majority of securitisation issuance involving distressed exposures is in actual facts securitisation of re-performing exposures, amounting to a total value of approximately EUR 3.3 billion for the period 2011-2017. Available data shows that for the mentioned period seven re-performing securitisation transactions were issued in total, across Ireland, Spain and the UK. Some of these transactions were publicly placed whereas others were privately placed.
245. Whereas in the case of the securitisations of re-performing exposures the only asset class is mortgage loans, in the case of the NPL transactions two transactions are backed by a mixed mortgage/unsecured exposures pool.
246. According to anecdotal evidence available to the EBA, post crisis NPL securitisation issuance is not limited to the values recorded within the publicly available information that is reported in this Discussion Paper. Numerous bilaterally-placed transactions that took place in the same reference period, in multiple jurisdictions on the basis of both secured and unsecured portfolios, may not have been captured in the datasets used for the purposes of this Discussion Paper.

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<sup>34</sup> Gross book value EUR 938 million: A note (senior) for EUR 267.4 million (29% of GBV, rated A3), B note for EUR 30.5 million (3% of GBV, rated B3) and J note for EUR 11.8 million (1% of GBV, unrated).

<sup>35</sup> Gross book value EUR 1.4 billion: Senior note for EUR 464 million (33% of GBV, rated), Mezzanine note for EUR 42.5 million (3% of GBV, rated), Junior note for EUR 20 million (1% of GBV, unrated).

Figure 18: Issuance of NPL and re-performing securitisation transactions as per available data



## 4.2 The market practice of NPL transfer

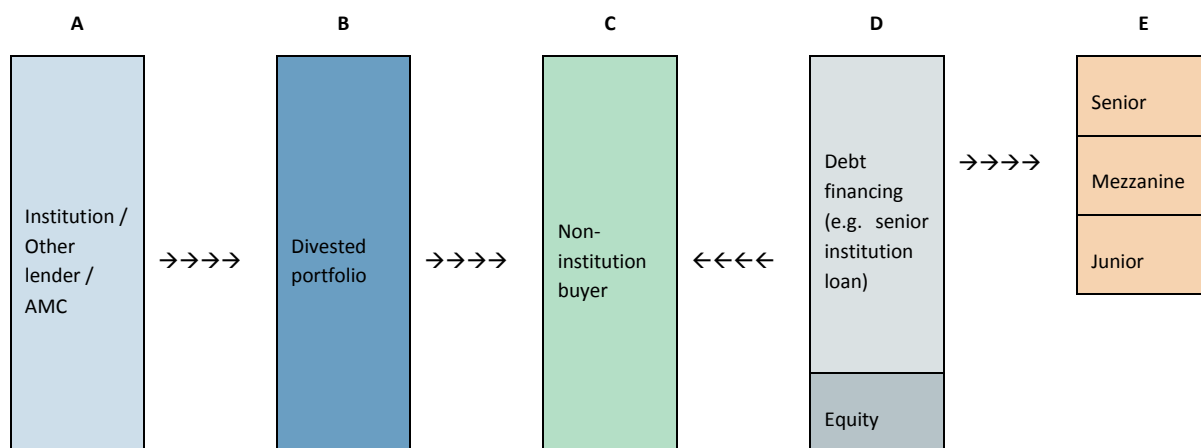
### 4.2.1 Transfer model

247. The transfer of distressed or non-performing exposures from institutions and other specialised lenders to third party investors, in recent years, has followed a variety of market practices, some of which foresee a role for and/or a phase of asset securitisation.
248. Portfolio divestment/transfer, which is commonly carried out not only in relation to NPLs but also, for instance, to non-core portfolios, has given rise to, at least the following, transactions:
- a. **Direct institution'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 in Figure 19);
  - b. **Portfolio sale to non-institution investor (e.g. private equity firm):** the originator sells the NPL/non-core portfolio to a non-institution investor, who purchases using its own capital (steps A+B+C in Figure 19) or partly leveraged through debt finance (e.g. senior institution loan, steps A+B+C+D in Figure 19), only keeping an equity stake.
249. When purchasing NPL/non-core portfolios, non-institution investors may choose to refinance them through securitisation transactions (steps A + B + C + D + E in Figure 19). In

the case of NPL portfolios, the scope of the securitisation solution may be limited, due to the fact that NPLs may not ensure a sufficiently regular stream of payments (i.e. recoveries) needed to remunerate noteholders, particularly junior noteholders in the securitisation structure. In some cases the securitisation solution is only adopted once a sufficient number of the underlying NPLs become re-performing, improving the prospect of regular cash flows for the securitisation transaction.

250. The portfolio divestment/transfer structures illustrated in Figure 19, below, apply not only to originating institutions (credit institutions and investment firms) in the context of NPL/non-core portfolio transfer, but also to lending platforms, other non-regulated lenders and asset management companies or bad institutions who have in turn acquired portfolios from originator entities.

Figure 19: Different forms of portfolio divestment/transfer



251. In some jurisdictions the transfer (sale) of NPL portfolios off institutions' balance sheets was organised by setting up (special) asset management companies (AMC), often called 'bad institutions'. These structures purchase NPL portfolios from originator institutions and manage them independently, normally with a view to selling them in the market as market conditions improve. The structures were set up with the aim of allowing originator institutions to clear their balance sheets, revert to their core performing business, while not necessarily becoming exposed to the losses of fire sales in depressed market conditions.
252. The jurisdictions where such structures were deployed are: Spain (SAREB), Ireland (NAMA) and Slovenia (BAMC). In the UK the UK Asset Resolution (UKAR) took over the portfolios of Bradford and Bingley and NRAM.

#### 4.2.2 The core elements of the NPL securitisation process

253. As discussed in the previous section, securitisation of NPLs may be a risk transfer tool adopted by the originator directly or by non-institution buyers that purchase NPL

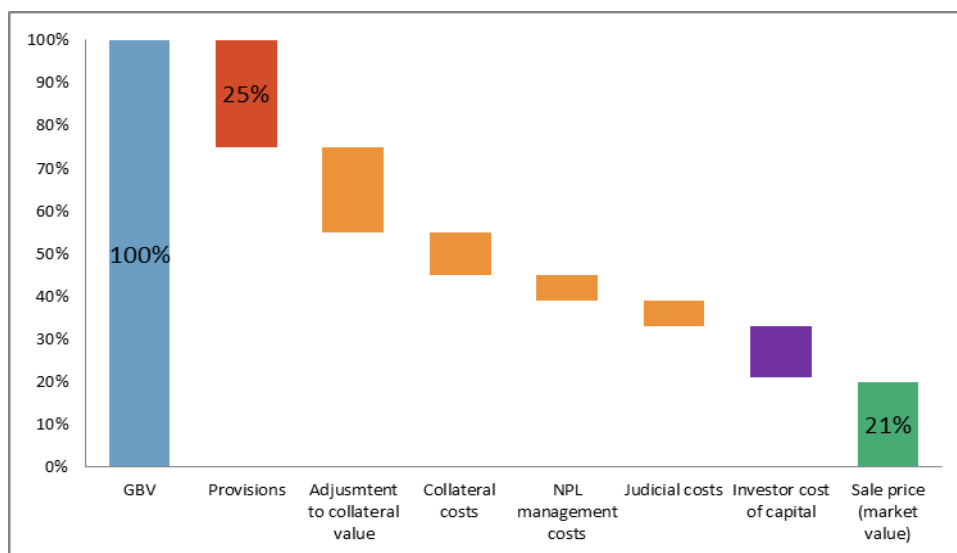
portfolios, as a first step, from originators. In either case, NPL securitisation (traditional securitisation) embeds a portfolio sale transaction. Several core elements of the process of NPL sale determine the viability and success of the transfer. In particular:

- a. **Due diligence and valuation:** the emergence of specialised investors with in-house or partner servicers reflects the complexity of the specific valuation and other due-diligence skills needed when acquiring NPL portfolios. Portfolio analysis and valuation, which is crucial from an investor (buyer) perspective in order to formulate a business plan and a final (bid) pricing of the portfolio, involves among other activities: (i) borrowers' creditworthiness analysis; (ii) statistical analysis of historical recovery performance of the class of exposures under consideration; (iii) cash flow analysis and valuation of the specific collateral securing the defaulted exposures; (iv) analysis of the judicial or other type of insolvency national frameworks applicable to the portfolio;
- b. **Data availability, transparency and standardisation:** the quantity and quality of data disclosed by the originator institution in the context of the transaction and/or otherwise available data on the NPLs impact on the length and costs of the investor's due diligence and valuation analysis, ultimately impacting on the (bid) pricing;
- c. **Alignment of interests (servicing):** the servicing activity is particularly relevant in the context of NPL management, as the quality of servicing is the main driver of the recovery prospects on the defaulted exposures and hence the overall profitability of the operation. From an investor perspective it is often deemed crucial that the servicing of the defaulted exposures is either allocated to a specialised and ring-fenced department of the originator or, more often, to specialised third-party servicers. This, in order to mitigate conflicts of interest potentially arising between originators and investors as well as to leverage on the specific skills developed by specialised market players in the due diligence and valuation activities;
- d. **Efficiency of the insolvency framework:** the efficiency and quality of the judicial or extra-judicial insolvency and foreclosure frameworks impact on the level, as well as the timing and predictability of the recoveries, determining different levels of bid prices;
- e. **Provisioning practices by the originator institution:** the level of provisions allocated by the selling institution to the NPL portfolio determines the portfolio's net book value (NBV) on the institutions' balance sheet. The higher the level of provisions, the lower the portfolio's NBV. Any additional discount that the agreed sale price applies on the NBV, flagging a discrepancy of valuations between seller and buyer, normally constitutes an additional loss that the originator has to absorb at the time of the sale. Levels of provisions below the available market valuations

of the NPL portfolio imply, other things being equal, a disincentive for the originator to opt for the portfolio sale.

254. Overall, elements (a) to (e) impact on the bid-ask price gap that characterises NPL portfolio sales (the gap between the portfolio's net book value and the price offered by the investor), with a wider bid-ask price gap making the portfolio sale less viable and less likely to be executed. Among other factors, these elements have so far contributed to keeping the investor base of the NPL market fairly limited in relative terms, i.e. compared with the volume of NPLs European institutions may be looking to dispose of.
255. The investor perspective provides insights on the relative role of different cost components in determining the bid-ask price gap, whereby the investor's cost of capital (i.e. the remuneration for the investment) is only one of the factors. Figure 20, below, provides an example of how a bid-ask price gap equal to 54 percentage points<sup>36</sup> may be decomposed. The example is only illustrative and abstracts from very relevant factors such as the type of underlying collateral as well as the jurisdiction governing the transaction's contracts.
256. Investors acknowledge that improving the functioning of the NPL market and mitigating the market failures that characterise it, would contribute to reducing the relative impact of the cost components represented in Figure 20.

**Figure 20: The costs of NPL resolution: investor perspective (illustrative example – sources Arrow Global and EBA calculations)**



257. According to evidence gathered by the EBA on the current market practice, the above mentioned factors play a different role, depending on how the portfolios can be classified across several dimensions, including but not limited to the following:

<sup>36</sup> In the transaction exemplified in Figure 20 the bid-ask gap of 54 percentage points results from the difference between the net book value (75%) and the sale price (21%).



- a. **Granular vs. concentrated portfolios:** in the case of very granular portfolios the due diligence and valuation analysis tends to be more statistical and standardised in nature, increasing the predictability of the portfolio cash flows and reducing the complexity, length and costs of the analysis. Lumpy portfolios normally require more in-depth loan-by-loan analysis, with more pronounced uncertainty around valuations cash flows;
  - b. **Unsecured vs. secured exposures:** portfolios of unsecured exposures, although they guarantee a substantially lower average recovery rate due to the absence of any collateral, are not subject to the complexities of collateral valuation and foreclosure on collateral (e.g. land and property valuation, interactions among multiple liens, judicial processes and legal systems etc.) that vary not only across Member States but also across different geographical areas within one jurisdiction. A lower valuation complexity may, in some instances, reduce the discrepancy between the selling institution's provisions, i.e. the seller's valuation, and the buyer's bid price, i.e. the investor's valuation;
  - c. **Homogeneous vs. mixed portfolios:** portfolios that are homogenous, e.g. in terms of asset class, geographical location of the exposures but also, for instance, secured vs. unsecured nature, tend to be easier to analyze and value, particularly as specialised investors tend to develop due diligence and valuation skills separately for different types of exposures and/or geographical areas.
258. For the NPL portfolio transfer to be structured successfully in the form of a traditional securitisation, additional core factors have to be considered:
- a. **Remuneration of the subordinated (i.e. junior) investor:** as NPL portfolios are often characterised by uncertain and non-predictable cash flows, linked to the timeliness of recoveries, the investors in the most subordinated tranches of the structure may risk seeing their investment start repaying late in the life of the transaction. The time-value of money, in these cases, may be such that investors either do not have sufficient appetite or require a level of remuneration that is not viable for the institution originating the securitisation. For this reason, the securitisation of NPLs becomes more viable as a sufficient portion of the underlying exposures become re-performing loans;
  - b. **Alignment of interest and servicing:** as mentioned, direct control over the servicing of the NPLs is a crucial condition for certain specialised investors. When this is the case, third party investors may prefer to purchase the whole NPL portfolio to ensure they can either run the servicing in-house or delegate it to specialised servicers, rather than investing in a tranche of the securitised NPL portfolio and not being able to control the servicing;

- c. **Regulatory treatment applicable to the originator:** for the securitisation transaction to fully achieve its balance sheet cleaning purposes, the originator has to be able to achieve accounting de-recognition of the securitised NPL portfolio and significant risk transfer, the latter accompanied by a workable regulatory capital relief (see section 4.3 for more details on the regulatory treatment of NPL securitisation applicable to the originator).

### 4.2.3 NPL securitisation and public guarantees

259. In order to facilitate institutions' disposal of NPLs, the Italian government introduced in February 2016 a guarantee scheme applicable to NPL securitisation transactions. The Italian government committed to provide state guarantees, priced at market conditions, on the senior securitisation tranches of securitisation transactions (i.e. to the benefit of the senior noteholders) backed by NPLs of Italian institutions, under the following conditions:

- a. The underlying exposures are transferred to the SSPE for a purchase price not higher than their net book value (i.e. gross book value net of depreciations) as resulting from the relevant institution's balance-sheets;
- b. The SSPE issues at least two tranches;
- c. The junior tranche is redeemed or repaid only if the other tranches have been redeemed in full;
- d. The SSPE may issue one or more tranches of mezzanine notes, whose interest payments are subordinated to the payment of interests of the senior notes but are paid in priority to the repayment of principal of the senior notes;
- e. The SSPE may enter into financial hedging agreements with market counterparties in order to reduce interest rate risks;
- f. For the purpose of managing the risk of mismatch between the recoveries and the amount due as interests on the securitisation tranches, a credit facility can be provided for an amount sufficient to keep the minimum level of financial flexibility consistent with the creditworthiness of the senior tranche;
- g. The senior tranches receive one (or two, as applicable in the legislation) ECAIs' rating corresponding to, at least, an investment grade level, or a private rating by a rating agency disclosed to the Italian authorities and always corresponding to, at least, an investment grade level;
- h. The servicing of the securitised exposures is mandated to an entity other than the originator institution.

260. The guarantee is only applicable to those transactions that transfer risks and rewards to the extent necessary to achieve accounting deconsolidation of the securitised exposures.
261. At the time of writing, one NPL transaction was closed in Italy under the GACS guarantee scheme in 2016, whereas two additional NPL transactions announced for 2017 are expected to benefit from the scheme.
262. The public guarantee on the senior tranche is expected to bring, among others, the following benefits:
- a. It allows the senior note of the structure to achieve higher rating levels and/or lower levels of required credit enhancement, hence (other things being equal) decreasing overall funding costs;
  - b. In those cases where the senior tranche is retained by the issuer, it substantially decreases the capital costs of retaining such tranche (due to the credit risk mitigation framework the originator is allowed to apply);
  - c. By flagging interest and support by the government it is likely to attract a wider investor base.
263. Among the limitations discussed in relation to this type of public guarantee scheme, from an investor's perspective, the following have been mentioned:
- a. The timing of the payments under the guarantee scheme may not be compatible with investors' expectations;
  - b. By targeting most senior risk, a senior guarantee scheme does not necessarily improve the profitability prospects of mezzanine and junior investors, which tend to be the categories of investors that are most needed and most difficult to attract into NPL securitisation. In this respect, the senior guarantee fees are in actual facts resources that are diverted away from the repayment of mezzanine and junior obligations;
  - c. Similarly, by requiring a pre-enforcement sequential principal payments waterfall the specific scheme may be less attractive to private junior investors.
264. It should also be noted, however, that the structuring of a public guarantee scheme such as the GACS scheme cannot exclusively be done taking into account the investor perspective. The mechanics of any public support scheme have to abide by the European law on State Aid; they must be structured to comply with the national law and regulations governing the implementation of public interventions in the market and with a view to always appropriately limit the risk taken up by the public sector.
265. Also on the backdrop of these limitations of the public guarantee scheme to senior tranches, as exemplified to date by the Italian GACS, some stakeholders advocated for the

need of public initiatives of co-investment (i.e. guarantee) targeting more junior risk. ECB research<sup>37</sup> has for instance discussed the role of a junior guarantee scheme limited to less than 100% of the junior tranche (e.g. 50%), whereby both the government and private equity investors would share junior risk, hence improving the alignment of incentives in the transaction and minimising potential moral hazard implications linked to the public intervention.

## 4.3 The regulatory treatment of NPL securitisation applicable to the originator

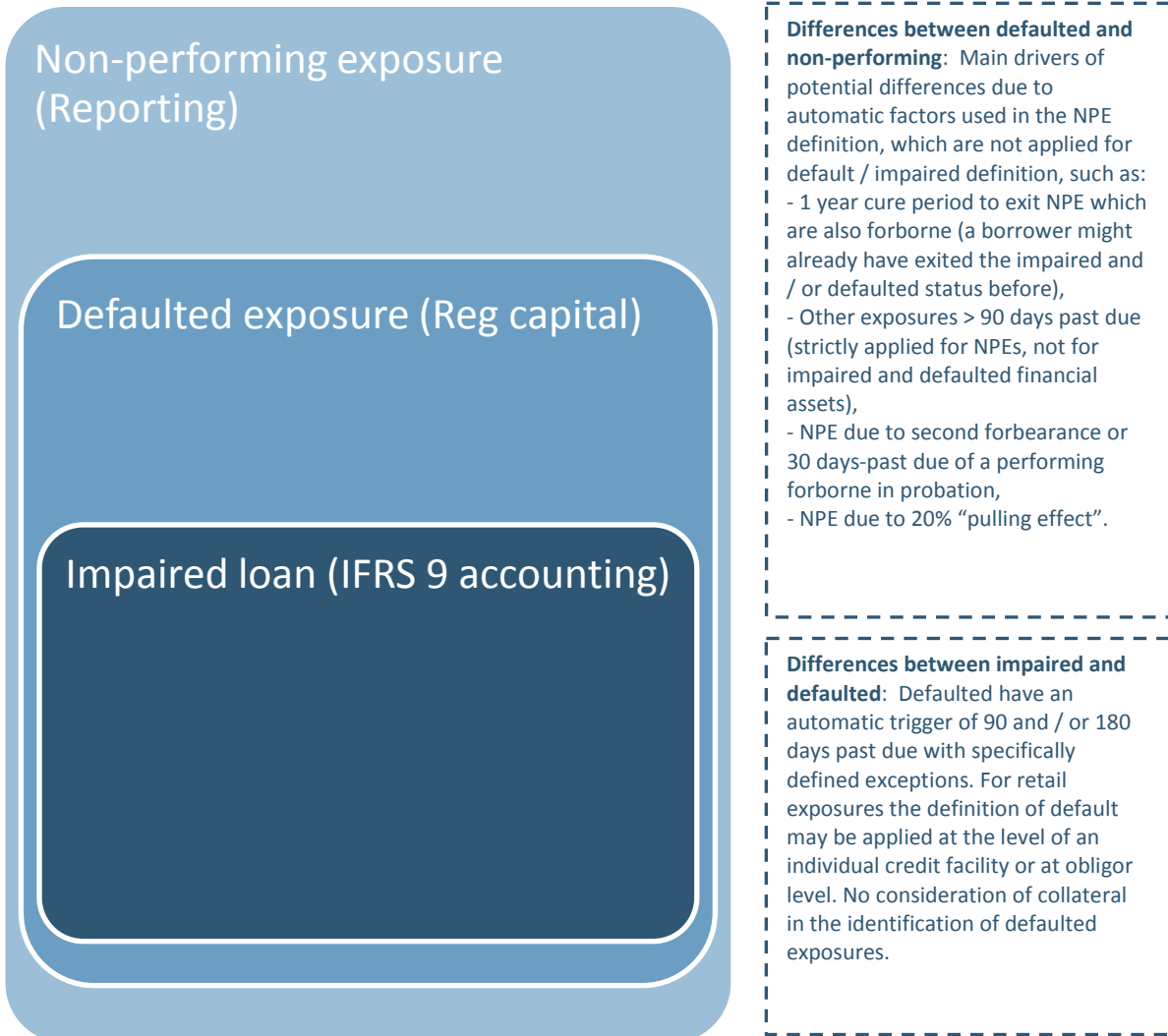
### 4.3.1 The definition of NPL

266. Asset quality can be measured according to different metrics based on accounting, prudential or reporting definitions:
- a. Impaired asset, based on the accounting definition (IFRS9 and / or local GAAP);
  - b. Defaulted asset, based on the prudential (CRR) definition;
  - c. Non performing exposure (NPE), based on the EBA definition (ITS) for supervisory reporting.
267. Even though the three definitions serve different regulatory purposes and target different audiences, they are ultimately expected to lead to convergent definition outcomes.

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<sup>37</sup> 'Resolving non-performing loans: a role for securitisation and other financial structures?', by J. Fell, C. Moldovan and E. O'Brien. Available at: <https://www.ecb.europa.eu/pub/fsr/shared/pdf/sfcfinancialstabilityreview201705.en.pdf?af953cafd6561fd288c85126163c7c04>

Figure 21: Summary of differences among existing definitions of asset quality



### 4.3.2 The accounting treatment of NPL securitisation

268. Accounting regulation is of paramount importance in relation to NPL securitisation, as the accounting de-recognition of the securitised NPLs is, together with significant risk transfer and regulatory capital relief, among the main objectives of NPL securitisation. NPL securitisation serves as a tool for institutions to do balance sheet cleaning, which can only be achieved if the securitised exposures are ultimately de-recognised from the originator's accounts.
269. Also, accounting regulation is what determines the methodology and level of provisioning (credit risk adjustments) institutions take against their non-performing exposures, whereby, other things being equal, higher levels of provisions reduce the bid-ask price gap that characterises the transaction.

#### Consolidation of the SSPE and accounting de-recognition of the securitised exposures

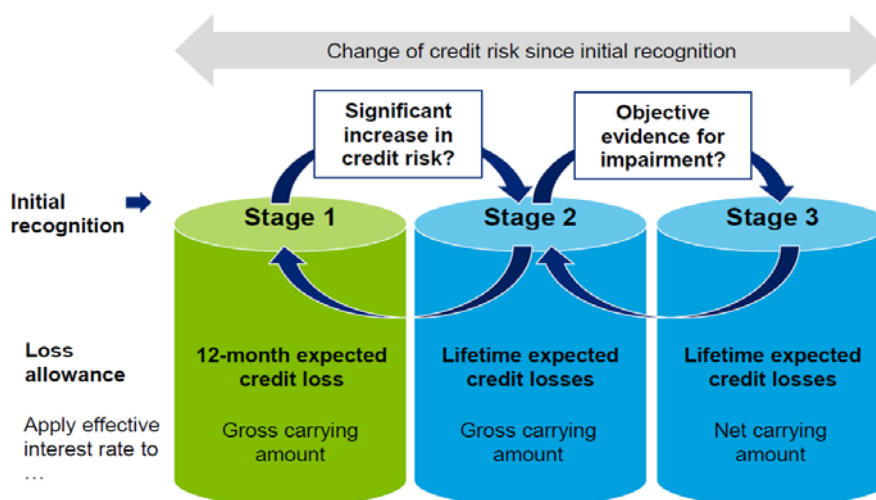
270. In accounting for securitisations there are two major determinations to be done, in the order:
- a. Is the SSPE to be consolidated to the originator's group?
  - b. Can the securitised exposures be de-recognised by the originator?
271. The consolidation of the SSPE where the NPLs are transferred is going to be governed by the reformed IFRS 10. These standards are based on a control model, whereby the originator entity has to determine whether it has power to direct the relevant activities, if it has exposure or rights to variable returns deriving from the involvement with the investee and whether it has the power over the investee to affect the amount of returns. If the answer to all of the previous questions is yes, the originator (group) has a controlling financial interest and therefore has to consolidate the SSPE.
272. The accounting de-recognition of the securitised NPLs is going to be governed by the reviewed IFRS 9. The recognition and de-recognition requirements in IFRS 9 will be unchanged from the requirements of the currently applicable IAS 39. The originator (the transferor for accounting purposes) will have to assess, step-by-step, whether the conditions for de-recognition are fulfilled, i.e. in sequential order:
- a. Have the rights to the cash flows from the transferred asset expired?
  - b. Has the entity transferred its rights to receive the cash flows from the transferred asset?
  - c. Has the entity retained substantially all the risks and rewards of ownership of the transferred asset?
  - d. Has the entity retained control of the transferred asset?

273. Whereas in the context of securitisation transactions (both performing and non-performing) exposures cannot achieve de-recognition on the basis of the above condition (a), the originator usually achieves the transfer of its rights to the cash flows from the transferred assets (condition (b)). Even retaining servicing tasks and rewards does not imply that the rights to the cash flows may not have been fully transferred.
274. However, beyond conditions (a) and (b), the accounting framework requires verifying whether the institution is retaining substantially all the risks and rewards of ownership of the transferred exposures. This last condition, whereby the market practice normally takes 'substantially' to refer to no more than 10% of the exposure to the variability of the present value of cash flows post-transfer, may be undermined by the cumulative impact of several transaction features. These may include retained servicing responsibilities against fees and retention of risk in the securitisation transaction to fulfill the CRR risk retention rules. Servicing rewards may be particularly high in the case of NPL securitisation, where servicing is the core activity determining the predictability of cash flows and the overall profitability of the transaction.
275. Provided that de-recognition can be achieved on the basis of the risks and rewards criterion, the institution has to assess whether it is retaining control on the underlying exposures (condition (d) above).
276. The monitoring of market and supervisory practices in the area of significant risk transfer highlighted that, in some cases, securitisation transactions achieve accounting de-recognition but are not granted significant risk transfer. In these instances, the EBA expects originator institutions to include the securitised exposures in the calculation of their risk-weighted assets amounts, irrespective of the accounting de-recognition decision. It is important that, in the absence of SRT recognition, the originator's prudential balance sheet reflect at all times the risk arising from the securitised portfolio.

#### Provisions (credit risk adjustments)

277. With the entry into force of the IFRS 9 (January 2018), the accounting approach under IFRS 9 accounting model for determining provisions will change from an 'incurred loss model' to an 'expected loss model'. In particular, in accordance with a three-step approach, institutions will have to take provisions as follows:

Figure 22: Impairment requirements under IFRS 9 (sources: Deloitte)



278. The three-stage approach, and in particular the requirement to take provisions for lifetime expected losses when a significant increase in credit risk occurs and ahead of objective evidence of impairment is expected to improve the timeliness of provisions and increase the level of provisions taken in the banking system. In this regard, the IFRS 9 is likely to contribute to address, at least in part, the problem of insufficient provisioning in the market of NPLs.

279.

#### 4.4 Pre- and post-securitisation own funds requirements in NPL securitisation

280. The relationship between own funds requirements applicable to NPL portfolios (i.e. pre-securitisation capital) and own funds requirements applicable on NPL securitisation positions (i.e. post-securitisation capital) is crucial in, at least, the following respects:

- a. It illustrates the extent of capital relief that an institution may achieve when disposing of NPLs through a securitisation transaction while, where applicable, retaining certain securitisation positions, determining the economic viability of NPL transfer through the securitisation technique;
- b. It sheds light on whether the design of the existing SRT regulatory framework includes any element that may work as an unintended impediment to the use of securitisation as an NPL transfer technique. Equally, it helps understand whether the SRT and commensurate risk transfer quantitative tests described in this Discussion Paper as potential proposals to amend the current SRT framework may be workable for NPL securitisation;



- c. It sheds light on the incentives posed to investor institutions when it comes to the choice of investing in NPLs via alternative routes, i.e. whole NPL portfolio acquisitions vs. investment in NPL securitisation tranches, determining the incentives of institutions to take part in the NPL securitisation investor base.

### Pre-securitisation own funds requirements (credit risk framework)

Figure 23: Own funds requirements on NPL exposures

	IRB institution		SA institution
	F-IRB	A-IRB	
<b>RWEA component</b>	Risk weight = 0	Risk weight = $\max\{0, 12.5 * (\text{LGDD} - \text{ELbe})\}$	<u>Unsecured component:</u> Risk weight 150%: if specific CRAs < 20% of gross unsecured exposure value; Risk weight 100% if specific CRAs $\geq$ 20% of gross unsecured exposure value. <u>Secured component:</u> Risk weight 100% on secured EAD after CRAs.
<b>Own Funds component</b>	IRB excess (+)/shortfall (-) = (Gen/Spec CRAs) - LGD <sup>38</sup>	IRB excess (+)/shortfall (-) = (Gen/Spec CRAs) - ELbe	General provisions may be added to Tier 2 capital up to 1,25 % of risk-weighted exposure amounts.
Where:			
EL	=	Expected Loss	
ELbe	=	Expected Loss Best Estimate for defaulted exposures	
LGDD	=	Loss Given Default	
LGDD	=	Loss Given Default in Default	
CRA	=	Credit Risk Adjustment	

281. Own funds requirements on NPL exposures under the SA framework comprise of an RWEA component and an own funds adjustment linked to provisions. Specific provisions taken in accordance with the applicable accounting framework play a twofold role: (i) they reduce the exposure value used as a basis to compute RWEAs; and (ii) on the basis of a 20% threshold relative to the gross unsecured exposure value they determine whether a 100% or 150% risk weight is applicable to unsecured defaulted exposures. The risk weight applicable to the secured part of a defaulted exposure equals 100%. The own funds adjustment component relates to general provisions taken against NPL exposures, whereby such provisions may, under specific limits, be added back to Tier 2 capital.
282. Despite the high risk weights applied to defaulted exposures in the SA framework, high levels of provisions may lead to lower levels of the RWEA component of the requirement (EAD reduction effect).
283. The own funds requirements on NPL exposures, in the case of IRB institutions, are made of two components: (i) RWEA component and (ii) IRB excess/shortfall own funds adjustment.

<sup>38</sup> For F-IRB institutions the EL on NPLs corresponds to the supervisory LGD value applicable in accordance with the F-IRB framework, given that PD = 1 for NPL exposures.

284. The risk weight on defaulted exposures is equal to zero for institutions that use supervisory LGD values for their exposures to corporates, institutions, central governments and central institutions (F-IRB institutions), whereas it should be positive for institutions that have approved models for own-LGD estimation for their exposures to those types of obligors (of A-IRB institutions) and/or for their retail exposures, resulting from the difference between the estimated LGDD parameter (higher) and the estimated ELbe parameter (lower).
285. The EBA Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures<sup>39</sup> (consultation paper) specify what the ELbe and LGDD parameters aim to capture. A positive difference is expected to arise from the fact that the LGDD reflects, on top of the best estimate expected loss given current economic circumstances and exposure status, an estimate of the increase of loss rate caused by possible additional unexpected losses occurring during the recovery period, i.e. between date of default and final liquidation of the exposure, reflecting downturn conditions and a margin of conservatism (both factors should instead not be included in the ELbe). In other words, the difference between LGDD and ELbe determines the level of unexpected loss that is to be covered by the RWEA-based measure of capital.
286. The IRB excess/shortfall component is such that IRB institutions may add to Tier 2 capital (have to deduct from CET1 capital), under specific limits, the excess (shortfall) resulting from subtracting the EL amounts arising from NPL exposures (or estimated ELbe in the case of A-IRB institutions) from the amounts of general/specific CRAs taken against those exposures. The CRR, as further specified also in the EBA RTS on model validation<sup>40</sup>, provides that the IRB excess/shortfall calculation should be made for defaulted (NPL) and non-defaulted exposures separately.
287. As assessed by the EBA in the context of its work on the estimation of IRB parameters, and as confirmed by evidence included within market research, the average risk-weighted component (i.e. the UL component) of the requirement on NPL portfolios varies substantially across institutions within jurisdictions and across jurisdictions in the EU, from the value of zero to relatively higher risk weights. Such variability is due, among other reasons, to the documented differences between the F-IRB and A-IRB frameworks and, within the A-IRB framework, to different institutions' practices in the estimation of the ELbe and LGDD parameters. Divergence in practices was also identified by the EBA in relation to the calculation of the IRB excess/shortfall adjustment component.
288. The consultation paper of the EBA Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures, which are expected to result in a harmonisation of

<sup>39</sup> See the EBA consultation document published in November 2016: <https://www.eba.europa.eu/regulation-and-policy/model-validation/guidelines-on-pd-lgd-estimation-and-treatment-of-defaulted-assets>

<sup>40</sup> See the final RTS published by the EBA in July 2016: <https://www.eba.europa.eu/documents/10180/1525916/Final+Draft+RTS+on+Assessment+Methodology+for+IRB.pdf/e8373cbc-cc4b-4dd9-83b5-93c9657a39f0>

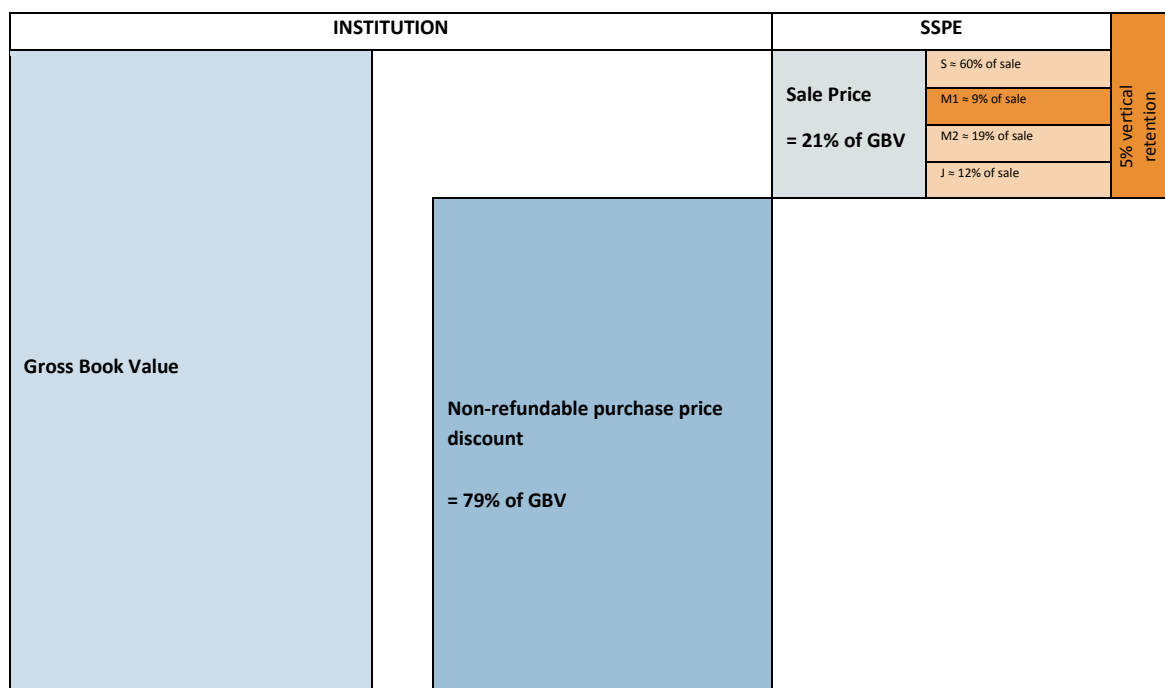
modelling practices also in the space of defaulted exposures (NPLs), proposed to give institutions time until 2021 to implement the required revisions of modelling practices.

### Post-securitisation own funds requirements (securitisation framework)

289. Within the assessment of the workability of the SRT framework for NPL transactions, the role and treatment of the non-refundable purchase price discount absorbed by the originator at the time of the sale emerges as, potentially, the most important aspect to be considered. In the context of NPL securitisation transactions the following elements should be considered:

- a. The sale transaction is typically characterised by a material gap between the GBV of the portfolio and the sale price, resulting in the so-called non-refundable purchase price discount (non-refundable purchase price discount represented by the dark blue area in Figure 24 amounts to approximately 80% of the GBV).
- b. The total exposure value of securitisation notes issued by the SSPE, amounting to the sale price, may represent a minor share of the GBV (the orange area in Figure 24 amounts to approximately 20% of the GBV).

Figure 24: An example of NPL securitisation transaction



290. Given the above specificities of NPL securitisation transactions, it is of particular importance to understand how the formulae-based approaches of the new EU securitisation framework (i.e. SEC-IRBA and SEC-SA approaches) are to be applied in the context of NPL securitisation.

291. The formulae-based approaches of the new CRR securitisation framework are based on the following principles:
- a. The non-neutrality approach to securitisation own funds requirements applies, whereby the total capital charge on a securitisation structure, i.e. the sum of the own funds requirements applicable to the individual tranches of the transaction, exceeds KIRB/KA, the latter being regulatory measures of both the expected and unexpected loss risk arising from the underlying portfolio<sup>41</sup>;
  - b. To implement the non-neutrality principle the formulae-based approach require all tranches that detach below KIRB/KA (i.e. that cover losses up until KIRB/KA) to be 1250% risk-weighted, to ensure the own funds requirements on these tranches fully cover the expected and unexpected losses of the underlying portfolio. The own funds requirements on the remaining tranches, i.e. those attaching above KIRB, add to the non-neutrality of the overall requirement with risk weights that duly decrease with increasing levels of available credit enhancement.
292. Unlike in securitisation transactions without a non-refundable purchase price discount, e.g. most securitisations of performing exposures, in NPL transactions such as the one illustrated in Figure 24, the fundamental question arises as to how the attachment and detachment points of the securitisation tranches should be determined.
293. In order to address this question, under the assumptions of the formulae-based approaches mentioned, it is important to recall the rationale of the new EU securitisation framework as well as the Basel securitisation framework.
294. The CRR amendment included in the new EU securitisation framework explicitly introduces the concept of ‘over-collateralisation’<sup>42</sup>, defined as ‘any form of credit enhancement by virtue of which underlying exposures are posted in value which is higher than the value of the securitisation positions’. If the ‘value’ referenced here is taken to correspond to the gross book value of the loans versus the value of the securitisation positions, this provision assigns an explicit credit enhancement role to the overcollateralization that results from transferring to the SSPE an NPL portfolio of a given GBV to a sale price that is lower than that GBV and which, in turn, determines the nominal value of the securitisation positions issued by the SSPE.
295. The same CRR amendment provides that the non-refundable purchase price discount on the securitised exposures (as well as the specific provisions taken on those exposures) can be deducted (in RWEA-equivalent amounts) by the originator institution from the RWAs

<sup>41</sup>  $K_{IRB} (\%) = (\text{risk-weight}) * 8\% + \text{one-year EL} (\%)$  and applies to institutions that are eligible to use SEC-IRBA.  $K_A = (1-W) * K_{SA} + W * 50\%$  and applies to institutions that are eligible to use SEC-SA.  $K_{SA}$  is the underlying own funds requirements (%) on an SA portfolio and W is the % of delinquencies measured within the portfolio. In the case of the NPL portfolios the RWA and EL components are determined as summarised in Figure 24, above.

<sup>42</sup> New Art. 242(9).

associated with securitisation positions that are 1250% risk weighted/CET1 deducted.<sup>43</sup> The general rationale of this deduction being that 1250% risk-weighted/CET1 deducted securitisation positions and specific provisions/non-refundable purchase price discounts are both assumed to cover expected losses on the securitised exposures, these standards aim to avoid double coverage of expected loss amounts and acknowledge a specific role for the non-refundable purchase price discount booked in the P&L of the originator<sup>44</sup>. The same possibility is foreseen under the Basel securitisation standards (Dec 2014 and July 2016 proposed revisions<sup>45</sup>).

296. Overall, the new EU securitisation framework seems backed by the principle that own funds requirements on a given transaction should be computed by looking at the risk profile of the securitised portfolio on the basis of its gross book value, and in particular assess which component of that risk has been absorbed by the non-refundable purchase price, rather than by focusing in isolation on the volume and risk profile of the securitisation notes issued by the SSPE.
297. On the backdrop of these considerations, it appears appropriate that the formulae-based approaches to securitisation capital as specified within the new CRR securitisation framework be applied on the basis of the gross book value of the transaction, i.e. including a credit enhancement role for the non-refundable purchase price discount absorbed by the originator institution.
298. Figure 25, below, shows the SEC-IRBA and SEC-SA risk weights that apply to the stylised NPL securitisation transaction already illustrated in this chapter, whereby a GBV approach is taken to the determination of the securitisation tranches' attachment and detachment points.
299. As a result of the approach taken in Figure 24:
  - a. The most junior tranche of the securitisation structure should be considered to attach at 79% and not at 0%;
  - b. The securitisation tranches receive risk weights that are lower than 1250%, reflecting the fact that the non-refundable purchase price discount acts as credit enhancement in excess of the regulatory measures of underlying risk.
300. If instead own funds requirements on the securitisation tranches were to be computed by looking at the securitisation structure in isolation, i.e. with the most junior tranche of the securitisation structure attaching at 0% and the purchase price discount not being

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<sup>43</sup> New Art. 248(1)(d)

<sup>44</sup> The CRR currently in force includes a very similar provision at Article 266(1), whereby however only credit risk adjustments may be deducted. The deduction of the non-refundable purchase price discount is not foreseen in Article 266(1).

<sup>45</sup> See Paragraph 37 of the 'Revisions to the securitisation framework' (Dec 2014 and July 2016).

considered as credit enhancement, most of the securitisation tranches in the transaction in Figure 5 would be assigned a 1250% risk weight.

301. The SEC-IRBA approach is applied under the assumption that the originator is an F-IRB institution. Representing the application of the SEC-IRBA approach in an A-IRB framework would require taking assumptions on the estimated ELbe and LGDD parameters. As mentioned, the current evidence available to the EBA shows that such parameters are being estimated in accordance with divergent practices across institutions and Member States, resulting in volatile average risk weights on defaulted exposures within the Single Market.
302. In conjunction with the application of the EBA Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures, the application of the advanced SEC-IRBA approach, particularly during down-turn conditions, should result in higher average measures of underlying portfolio risk (i.e. higher K<sub>IRB</sub>) on NPL transactions, if compared to the supervisory 45%/50% values that apply, respectively, under the foundation SEC-IRBA framework and SEC-SA framework. Other things being equal, higher parameters of underlying portfolio risk should result in SEC-IRBA on NPL tranches risk weights based on A-IRB parameters being higher than SEC-IRBA risk weights based on F-IRB parameters and SEC-SA risk weights.

**Figure 25: SEC-IRBA and SEC-SA risk weights on the stylised NPL transaction: GBV approach to tranche capital (see Box 5 for the underlying assumptions)**

Seniority	AP	DP	Thickness	SEC-IRBA (F-IRB) RW	SEC-SA RW
Senior	88%	100%	12%	34%	520%
Mezzanine 1	86%	88%	2%	56%	596%
Mezzanine 2	82%	86%	4%	70%	633%
Junior	79%	82%	3%	90%	679%
Non-refundable Purchase Price Discount	0%	79%	79%	/	/
<b>WHERE:</b>					
K <sub>IRB</sub> <sup>46</sup> /K <sub>A</sub> <sup>47</sup>				45%	50%
NRPPD				79%	79%

**Box 4: Assumptions underlying the risk weight calculation in Figure 24**

**SEC-IRBA (F-IRB) assumptions:**

- The institution using SEC-IRBA has an approved Foundation IRB model;
- PD = 100% (defaulted exposures);
- LGD = 45% (highest F-IRB LGD parameter for senior debt);
- EL = PD \* LGD = 45%
- $RWA_{portfolio} = 0$  (F-IRB rules);
- $K_{IRB} = RWA_{portfolio} * 8\% + EL = 45\%$ ;

**SEC-SA assumptions:**

- $K_{SA} = 8\%$  (100% risk weight under the assumption the whole portfolio is fully secured and/or there are high provisions on the non-secured component);
- $W = 100\%$  (delinquencies are at 100% in a portfolio where all exposures are in default)

<sup>46</sup>  $K_{IRB} = EL$  (for F-IRB institutions);  $K_{IRB} = LGGD = ELbe + conservatism/downturn$  (for A-IRB institutions);

<sup>47</sup>  $KA = (1-W) \times KSA + W \times 50\%$ ;

#### 4.4.1 Further considerations for stakeholders' consultation

303. *This Discussion Paper puts forward a set of proposals that aim at further strengthening and harmonising the regulation and supervision of securitisation transactions seeking recognition of significant risk transfer. The EBA is aware that some of those proposals, whereas they are fit for purpose in the case of securitisation transactions backed by performing exposures, may not be appropriate and/or may require further elaboration in the case of transactions in which NPLs are securitised;*
304. *Particularly the proposals dealing with certain core structural features of the securitisation transaction, e.g. amortisation structures or use of excess spread (see Section 3.2.2), as formulated in this Discussion Paper, may not take due account of the specificities of NPL securitisation transactions.*
305. *In the same vein, the EBA proposals on how to strengthen and further harmonise the quantitative assessment of risk transfer, through both significant risk transfer tests and commensurate risk transfer tests (see section 3.3.3), as specified in this Discussion Paper, may not be fully compatible with the specificities of NPL securitisation transactions. Such specificities include but are not limited to the presence of a non-refundable purchase price discount (portfolio sale at a price below par), as well as the defaulted exposures-specific regulatory treatment of expected and unexpected loss risk.*
306. *The EBA intends to use this consultation to gather further evidence and views on which aspects of the framework proposed here should be additionally tailored to the case of NPL transactions, with a view to making the proposals presented here fully compatible with the credit risk treatment of defaulted exposures as well as the new EU securitisation framework that will enter into force in conjunction with the new proposed Securitisation Regulation.*

**Question 27:** Do you agree with the assessment of the market practice of NPL transfer? Are there material aspects that are not covered in this representation?

**Question 28:** What conditions/initiatives would, in your view, facilitate the well-functioning of the NPL securitisation market?

**Question 29:** Which, in your view, are the core structural features that should be assessed within the SRT assessment of NPL securitisation transactions? Are the proposals on selected structural features of securitisation transactions proposed in this document (see section 3.2.2) equally valid for NPL securitisation transactions?

**Question 30:** Do you agree with the proposed way of implementing the SEC-IRBA and SEC-SA approaches for the calculation of securitisation tranche capital in the presence of a non-

**refundable purchase price discount? Do you envisage other ways to implement the mentioned approaches in the presence of a refundable purchase price discount?**

**Question 31: Do the SRT quantitative tests provided for in the CRR currently in force (Articles 243 and 244 of the CRR) work properly for NPL securitisation transactions? If not, please provide an explanation to your answer.**

**Question 32: How should the alternative commensurate risk transfer proposed in this report be modified to address the specificities of NPL securitisation transactions?**

**Question 33: How should the quantitative test proposed under Option 2 in this report (see section 3.3.2) be modified to address the specificities of NPL securitisation transactions?**



# Summary of the questions for stakeholders

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## **Overview of market practices with respect to SRT**

Question 1: Does the data on synthetic and traditional SRT securitisation transactions correspond with your assessment of SRT market activity in the EU? Do you have any observations on these data?

## **Overview of supervisory frameworks for assessment of SRT**

Question 2: Are you aware of any material supervisory practices that have not been covered in the EBA analysis?

## **Assessment and proposals for discussion in relation to the process of the SRT assessment**

Question 3: What are your views on the proposals on the assessment process set out above? Are any other changes necessary to further improve the process?

Question 4: Could you provide suggestions as to whether and how the template for SRT notification by the competent authority to EBA provided in Annex I of the EBA Guidelines<sup>48</sup> should be amended to reflect the new EU securitisation framework and the STS securitisation product?

Question 5: Should a standardised SRT notification template be developed, for submission by originators to competent authorities, in order to facilitate the SRT assessment process? If yes, should this template be different for traditional and synthetic securitisation? (Please provide examples of templates, as appropriate).

Question 6: Could you provide suggestions as to how a template for monitoring SRT compliance should look like (e.g. by potential amendments of the current COREP framework)?

## **Assessment and proposals for discussion with respect to selected structural features of SRT transactions**

Question 7: Do you agree with the assessment of the SRT implications of all the identified structural features? Are any material aspects missing from this representation?

Question 8: Do you agree with the proposed safeguards related to the use of pro-rata

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<sup>48</sup> See Annex I in the EBA Guidelines, available at: <https://www.eba.europa.eu/documents/10180/749215/EBA-GL-2014-05+Guidelines+on+Significant+Risk+Transfer.pdf>.

amortisation?

Question 9: Do you agree with the proposed safeguards related to the use of time calls? Do you agree with the different approach to time calls in traditional vs. synthetic transactions?

Question 10: Do you agree with the proposed safeguards on the use of excess spread in traditional securitisation?

Question 11: Do you agree with the proposed safeguards constraining the use of excess spread in synthetic securitisation? In particular, do you agree with:

- a. The proposal of only allowing a contractually fixed (pre-determined) excess spread commitment in synthetic transactions?
- b. The proposal to only allow a 'trap' excess spread allocation mechanism in synthetic transactions?

Question 12: Do you agree with the proposed way to treat the excess spread commitment in synthetic securitisation transactions for the purposes of the quantitative assessment of SRT and commensurate risk transfer?

Question 13: In relation to the further considerations for stakeholders' consultation on the own funds treatment of excess spread:

- a. Do you agree that the unrealised/unfunded component of the excess spread commitment should become subject to Pillar I own funds requirements?
- b. What would be the impact on SRT transactions if Pillar I own funds requirements were recognised as suggested in Section 3.2?

Question 14: Are there any other safeguards or alternative regulatory treatments to address risks retained through excess spread in traditional and synthetic securitisation?

Question 15: Should there be a specific treatment in those transactions featuring excess spread in which the originator, instead of achieving SRT in accordance with one of the SRT tests specified in the CRR, chooses to deduct all retained securitisation positions from CET 1 or apply a risk weight of 1250% to all of such securitisation positions ('full deduction option'), in order to be allowed to exclude the securitised exposures from the calculation of risk-weighted exposure amounts?

Question 16: What are your views on the use of originator's bankruptcy as an early termination clause? How does this clause interact with the resolution regime (i.e. the BBRD framework)? Should this clause be banned?

Question 17: Do you agree with the proposed originator's self-assessment of risk transfer? Should such assessment be formulated differently?

Question 18: Are you aware of circumstances where institutions have entered into a structured risk transfer transaction which is not captured by Articles 243 or 244 CRR? For example, where the accounting treatment has meant a transaction is not considered for SRT assessment, or where transactions economically similar to SRT transactions do not fall into the definition of a ‘traditional securitisation’ or ‘synthetic securitisation’.

**Assessment and options suggested by EBA with respect to the quantitative SRT tests**

Question 19: Do you agree with the proposed specification of the minimum first loss tranche thickness for the purpose of the first loss test?

Question 20: Do you agree with the proposed requirement of the minimum first loss thickness for the transactions assessed under the mezzanine test (i.e. transactions including mezzanine securitisation positions)? Do you consider this requirement relevant for all the approaches for calculation of securitisation own funds requirements (including e.g. SEC-ERBA)?

Question 21: Is a specification needed of the minimum thickness of tranches constituting mezzanine securitisation positions for the purpose of the mezzanine test?

Question 22: What impact do you expect the new CRR securitisation framework to have on tranches’ minimum thickness?

Question 23: Do you have any comments on the test of commensurate risk transfer proposed under Option 1?

Question 24: Do you have any comments on the test of SRT and commensurate risk transfer proposed under Option 2? In particular, is the 50% threshold for SRT therein needed and appropriate?

Question 25: Should the SRT test be different depending on asset classes? Should it differ across STS and non-STS transactions?

Question 26: Could you provide, on the basis of SRT transactions that are part of your securitisation business, an assessment of the impact in terms of SRT achievement of the proposed requirements under both Option 1 and Option 2, taking into account the new CRR securitisation framework (Securitisation Regulation package)?

**The regulatory treatment of NPL securitisation**

Question 27: Do you agree with the assessment of the market practice of NPL transfer? Are there material aspects that are not covered in this representation?

Question 28: What conditions/initiatives would, in your view, facilitate the well-functioning of the NPL securitisation market?

Question 29: Which, in your view, are the core structural features that should be assessed within the SRT assessment of NPL securitisation transactions? Are the proposals on selected structural features of securitisation transactions proposed in this document (see Section 3.2.2) equally valid for NPL securitisation transactions?

Question 30: Do you agree with the proposed way of implementing the SEC-IRBA and SEC-SA approaches for the calculation of securitisation tranche capital in the presence of a non-refundable purchase price discount? Do you envisage other ways to implement the mentioned approaches in the presence of a non-refundable purchase price discount?

Question 31: Do the SRT quantitative tests provided for in the CRR currently in force (Articles 243 and 244 of the CRR) work properly for NPL securitisation transactions? If not, please provide an explanation to your answer.

Question 32: How should the alternative commensurate risk transfer proposed in this report be modified to address the specificities of NPL securitisation transactions?

Question 33: How should the quantitative test proposed under Option 2 in this report (see Section 3.3.2) be modified to address the specificities of NPL securitisation transactions?

# Annexes

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## Annex 1: Analysis of supervisory frameworks used for the SRT assessment

307. Most information included in this section was collected by the EBA in 2016 through a questionnaire for competent authorities. 23 competent authorities<sup>49</sup> responded to the questionnaire; of these, 8 competent authorities provided in-depth and comprehensive information on their frameworks for SRT assessment. No response was received from 6 competent authorities.<sup>50</sup>
308. The information in the following overview principally and systematically covers the formal SRT supervisory frameworks developed in five EU jurisdictions (DE, IT, LU, UK and SSM). It also takes account of policies in the jurisdictions with no formal SRT frameworks, where specific non-standardised/non-formal practices exist on particular SRT-relevant issues.
309. In particular, supervisory practices in the following areas are examined:
- a. Process of the SRT assessment;
  - b. Assessment of the specific criteria listed in the EBA Guidelines that trigger a comprehensive assessment of SRT transaction (Title II of EBA Guidelines);
  - c. Assessment of certain core structural features of SRT transactions.
  - d. Other relevant aspects as part of competent authorities' comprehensive assessments.

### Process of the SRT assessment

#### Regulatory framework:

310. The EU regulatory framework (CRR, EBA Guidelines) does not set out rules on the process of the SRT assessment.

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<sup>49</sup> CAs that responded to EBA questionnaire on SRT: AT, BE, CY, CZ, DK, DE, EE, EL, ES, FI, FR, HU, IE, IT, LT, LU, NL, PT, SE, SI, SK, UK, SSM.

<sup>50</sup> CAs from which no response was received: BG, HR, LV, MT, PL, RO.

### Assessment:

311. There is a significant diversity in the supervisory practices as regards the procedural aspects of the SRT assessment, in various phases and steps of the process. In particular, high level of heterogeneity has been identified with respect to (i) the requirements on the notification/application for SRT that the originator submits to the competent authority; and (ii) the type and timing of the feedback provided by the competent authority to the originator regarding the achievement of SRT.

Figure 26: Overview of supervisory practices with respect to the process of the SRT assessment

Procedural step	Number of jur.	Additional information
<b>Notification of SRT transaction</b>		
Notification by originator required for any securitisation transaction seeking SRT recognition	8	In one jurisdiction, the originator is only invited to notify.
No formal notification requirements	2	In one jurisdiction, institutions inform about relevant upcoming events (including SRT transactions) in regular meetings of senior management with the CA.
<b>Timing of the SRT notification with respect to origination of the transaction/issuance</b>		
Notification required ex-ante	5	The period is different, extending up to three months before issuance (in two jurisdictions, at least three months before expected date of issuance; in one jurisdiction at least 2 months before applying Art. 245(1) of CRR i.e. calculation of the RWEA to securitisation; in another one at least one month before issuance). In one jurisdiction, no exact time is specified.
Notification required ex post	2	In one jurisdiction, the notification is required within one month after the date of the transfer. In one jurisdiction, the notification is required without delay after the origination of the transaction.
Notification accepted both pre- and post-issuance	1	
<b>Pre-discussions on the transactions prior to notifications</b>		
No formal requirements to discuss with the competent authorities the SRT transaction at an early stage, before submitting the official notifications	7	Pre-discussions normally take place as a common practice, on own initiative, or are expected or recommended by the competent authorities. In some frameworks, they take place in the context of on-going supervision. In one jurisdiction, no pre-discussions take place however informal dialogue on specific features of a transaction may take place once transaction has been notified. A number of competent authorities underlined that pre-discussions do not mean or guarantee formal approval of an SRT transaction, but can serve to obtain preliminary evaluation or increase the efficiency of the administration procedure.
<b>Timing of submission of information/documentation and content</b>		
Submission of information/documentation at the time of notification	8	The notification normally includes all the information and documentation needed by the CA to perform an assessment, in line with the CRR and EBA Guidelines. Several jurisdictions also outline minimum information the notification should include, such as details on internal SRT governance, rationale for the transaction, and other general transaction information as well as information on the securitisation positions and securitised exposures. One jurisdiction developed a template for originators to fill in as part of the notification. Jurisdictions generally allowed that information initially provided

Procedural step	Number of jur.	Additional information
		could be updated or supplemented as it becomes available.
Further submissions required after the notification	1	In one jurisdiction, once the transaction is finalised, originators should provide final version of all documents and information, no later than 15 days after the closing date of the transaction.
<b>Declaration by originator on achievement of SRT</b>		
Requirement to submit formal declaration, notifying the achievement of SRT	6	In one jurisdiction, formal declaration by the originator should be submitted that the securitisation meets the conditions stipulated in CRR Art. 243(2) and 244(2). When applicable, originators should indicate whether the transaction is similar to previous transactions already originated, and if not, highlight the changes.
No formal declaration required	4	
<b>Register of transactions</b>		
Register kept by the CA to record the SRT transactions	3	
No register kept, or no rules exist on keeping the register	6	
<b>Differences in the process of SRT transactions based on quantitative test vs. permission-based tests</b>		
Differences in the procedures	3	The processes mostly differ in terms of evidence to be provided by originator or decision-making processes. In one jurisdiction, in case of permission-based tests the decision on achievement of SRT has to be taken for all the transactions, while in case of quantitative tests the decision is only required for the transactions where it is concluded that the capital reduction is not justified by a commensurate risk transfer, and the originator decides to proceed with the issuance.
No differences in procedures	3	
<b>Notification of changes in the characteristics of the transaction</b>		
Obligation to notify the CA of any changes in the characteristics of the transaction	5	Conditions for such notification differ. Generally, originators should notify the competent authority in case of (i) changes to the initially agreed statutory conditions; (ii) changes to the characteristics of the SRT transaction; (iii) changes that impact on the commensurate risk transfer (such as changes to the provisions within the documentation due to noteholder action or bilateral agreement with relevant investors); (iv) in case the SRT requirements are otherwise no longer fulfilled (such as, pool deterioration or rating migration, which, in principle may lead to a subsequent de-recognition of the SRT); or (v) in case of amendments in relevant statutory provisions or relevant court judgements (where the institutions may be expected to update the opinion of qualified legal counsel required by the CRR). Notifications are also required in some jurisdictions before/after exercise of call options provided in the transaction documentation.
No specific processes in place	3	In one jurisdiction, when CA accepts an application for SRT, it will be included in the acceptance note that any changes to the transaction may result in the transaction not fulfilling SRT.
<b>Ongoing monitoring of SRT compliance by competent authorities (once the transaction has been granted SRT)</b>		
Specific processes exist	3	Specific processes exist in these jurisdictions, requiring also periodic/regular monitoring. In one jurisdiction, monitoring takes place as part of the annual audit. In one jurisdiction, originator should inform the CA of the evolution of the transaction on a quarterly basis. Based on the information, the initial assessment is updated to ensure it remains valid.
No specific/official process available	3	In one jurisdiction, the CA may reassess its judgment of the achievement of commensurate risk transfer if the level of credit

Procedural step	Number of jur.	Additional information
		enhancement in a transaction changes materially. Also, CA does conduct reviews of certain outstanding transactions on an ad hoc basis.
<b>Type of supervisory feedback to originator on the achievement of SRT</b>		
Feedback provided to the originator on the outcome of the SRT assessment	7	<p>Type of the feedback provided differs considerably across jurisdictions.</p> <p>In majority of cases, the feedback is provided both in case of positive or 'non-objection' SRT assessment (i.e. in case the SRT has been achieved) and negative SRT assessment (i.e. in case the SRT has not been achieved).</p> <p>In minority of cases, the feedback is only provided in case of negative SRT assessment.</p> <p>In some jurisdictions, feedback is provided also in other situations (such as in case the originator requires a permission in accordance with Art. 243(4) or 244(4) of CRR, or to inform the applicant on the start of the process).</p> <p>In some jurisdictions, preliminary assessment is provided before the final feedback, or the institutions are expected to discuss material or complex features at an early stage.</p>
No feedback provided	1	<p>The provision of feedback is not envisaged in formal supervisory rules in this jurisdiction, in case the originator relies on the quantitative tests in Art. 243(2) or 244(2) in CRR to demonstrate SRT (however, decisions are notified in accordance with general supervisory practices).</p> <p>The provision of feedback is envisaged in case the originator requires a prior approval in accordance with permission-based test (Art. 243(4) and 244(4)).</p> <p>The decisions are taken in a non-objection procedure.</p> <p>Streamlined processes apply in case of repeat or structurally similar transactions for a given institution.</p>
<b>Timing of the supervisory feedback to originator on the achievement of SRT</b>		
Explicit deadline envisaged for the supervisory feedback	3	Jurisdiction timelines for feedback ranges from within 60 days after the application to within six months after the application.
No ruling on timing	5	Timeline of the supervisory feedback to the originator is variable and no specific deadline is envisaged in the rules. The timeline may depend on the complexity of the assessment and may be provided after the transaction has closed. In one case the competent authority expects to be able to notify the decision within three months from the original notification received from the originator.
<b>Feedback from CA to proceed with closing of the transaction / issuance</b>		
No feedback required	8	
<b>Permission-based tests granted under Art. 243(4) of CRR: single vs multiple permissions</b>		
Permission required to be issued for each single transaction (i.e. permissions for multiple transactions are not allowed)	3	In one jurisdiction, fast-track procedures for multiple transactions could be considered in future.
Permissions for multiple transactions allowed	5	<p>Permissions for multiple transactions are available on a case by case/exceptional/limited basis in three jurisdictions.</p> <p>In another jurisdiction, permissions for multiple transactions are available if there is similarity in structure and portfolio composition to previous transactions notified by the institution to the regulator.</p> <p>In another jurisdiction, there is a published statement for granting permissions to multiple transactions. The statement outlines how to define the <u>scope</u> of multiple transactions and the factors which the CA's permission application reviews will focus on. Multiple transaction permissions will be granted for a</p>



Procedural step	Number of jur.	Additional information
		period of one year.

### Assessment of criteria triggering a comprehensive assessment of transactions

312. The EBA Guidelines provide competent authorities with a non-exhaustive list of circumstances under which a comprehensive assessment of the transaction by the competent authority is deemed necessary (Title II of the Guidelines). This section provides an overview of the supervisory practices in the assessment of the transaction characteristics that trigger a comprehensive assessment by the competent authority.

#### Transactions in the scope of the comprehensive assessment

##### Regulatory framework:

313. The CRR provides that competent authorities may execute a comprehensive assessment of transactions seeking SRT and deny SRT recognition to the transactions based on such assessment, on a case-by-case basis, when the transaction is considered not justified by a commensurate risk transfer despite meeting the quantitative tests prescribed in the CRR. The CRR does not however specify under which conditions the competent authority should assess such transactions to verify that SRT has actually occurred. The EBA Guidelines provide the competent authorities with a non-exhaustive list of circumstances under which a comprehensive assessment of the transaction by the competent authority is deemed necessary.

314. As an alternative to the quantitative tests, according to the CRR the originators may request the CA for the permission to consider SRT to have been achieved, without needing to rely on the quantitative test. All the transactions for which a permission has been requested by the originator are subject to the comprehensive assessment.

##### Assessment:

315. Competent authorities generally assess all the criteria specified in the EBA Guidelines for every securitisation transaction to see if a comprehensive assessment is required. A comprehensive assessment is conducted when the transaction falls within one or more of the criteria. In most jurisdictions, no additional criteria are checked on top of those specified in the EBA Guidelines.

316. In case of one jurisdiction, a comprehensive assessment is always required if the originator intends to demonstrate the SRT to third parties in the absence of an ECAI rating. In practice this captures a large number of transactions. The comprehensive assessment also focuses on new transactions and prototypes, and on transactions originated by entities with limited

or no experience in securitisation. In another jurisdiction, a comprehensive assessment is in practice conducted on all the transactions claiming SRT.

### Assessment of tranche thickness where a mezzanine tranche exists

#### Regulatory framework:

317. The CRR does not prescribe any specific provisions on the thickness of the tranches used to demonstrate SRT for transactions where a mezzanine tranche exists. The EBA Guidelines specify that the securitisation tranche that is used to demonstrate the SRT should be assessed with regard to (i) the special credit risk profile and (ii) the corresponding RWEAs of the securitised exposures.

#### Assessment:

318. Generally, there are no specific or systematic approaches in national supervisory practices on how the tranche thickness is assessed, beyond the guidance in the EBA Guidelines. The assessments may focus on a comparison with previously assessed transactions, with other parameters such as historical losses, or on the detachment point to be greater than some measure of risk being transferred.

319. In the case of one jurisdiction, if the first loss tranche is retained by the originator, and there exists a mezzanine position transferred to third parties, an assessment is made on whether the first loss tranche's thickness prevents significant losses being passed on the third party.

### Margin over the expected loss in assessment of thickness of first loss tranche

#### Regulatory framework:

320. The CRR requires, as one of the conditions of the quantitative SRT test applicable to transactions without mezzanine tranches, that the exposure value of the securitisation positions that would be subject to CET1 deduction/1250% risk weights, exceeds a reasoned estimate of the expected loss on the securitised exposures by a substantial margin.

321. The EBA Guidelines include expected loss as one of the criteria to be checked for the purposes of the comprehensive assessment. More concretely, they specify that a comprehensive assessment should be conducted in case the originator's reasoned estimate of the expected loss on the securitised exposures until the maturity of the transaction may be too low to consider that significant risk has been transferred. The total maturity of the transaction, and the potential existence of excess spread, should be taken into account in this assessment. The EBA Guidelines also specify that the comprehensive assessment should also be conducted in case the margin is too low to consider that significant credit risk has been transferred.

#### Assessment:

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322. Practices differ as to how the expected loss is measured for the purposes of the comprehensive assessment. In particular there are differences in approaches as to (i) whether one-year or lifetime expected loss is considered; (ii) whether regulatory (one-year) expected loss is required or lifetime (economic) expected loss is also accepted for the purposes of the assessment; (iii) whether the computation of expected loss is required for institutions using IRB models only or also for institutions determining own funds requirements in accordance with the Standardised Approach. Competent authorities generally assess the robustness of institutions' approach to calculating the EL. For the institutions using IRB models, it is assessed whether the institution has all the required permissions and understanding to use IRB models. For institutions using the SA method, a detailed description of the methodology used to compute the EL is requested.
323. Supervisory approaches also differ as to what can be considered a substantial margin, in particular in terms of:
- a. the focus of supervisory considerations in respect of the time horizon (one-year or lifetime), whether EL or EL+UL considered, and whether regulatory parameters are necessary or economic parameters (institution's estimates) are also accepted; and
  - b. the supervisory expectations/specific formulae used for the calculation of such substantial margin. Some authorities focus on the amount of UL transferred to third parties, whereas others consider the detachment point of the junior tranche.

### ECAI ratings

#### Regulatory framework:

324. The EBA Guidelines specify the following as conditions requiring a comprehensive assessment: (i) when there are doubts regarding the appropriateness of a particular rating of an ECAI; and (ii) when an originator intends to demonstrate the SRT in the absence of an ECAI rating for the relevant tranches.
325. Art. 268 of the CRR specifies the requirements to be met by the ECAI rating for the purposes of calculating RWEAs, according to the securitisation framework. The ITS on the mapping of ECAIs' credit assessments for securitisation positions provide the correspondence between credit ratings and credit quality steps that determine the allocation of risk weights to credit ratings assigned by ECAIs to securitisations where the SA or IRB approach for securitisations are used.

#### Assessment:

326. In a majority of jurisdictions, there are no systematic/specific approaches to assess the appropriateness of an ECAI's credit assessments, or specific factors considered in such assessments, beyond the provisions in the CRR and the EBA Guidelines.

327. Systematic approaches for the assessment of an ECAI's rating exist in a minority of jurisdictions. Factors considered to assess the appropriateness of the rating include the experience of the ECAI in the asset class being securitised, and whether unexplained changes in the nominated ECAs indicate that 'ratings shopping' may have taken place. In another jurisdiction, in cases where the originator has selected only ECAs with limited experience in rating securitisation positions, it is assessed how credible is the justification for selecting such ECAs.
328. One jurisdiction specified that if the originator intends to demonstrate SRT in the absence of an ECAI rating, a comprehensive review is always required (this is especially relevant when the originator intends to use the Supervisory Formula Method of the current CRR securitisation framework to determine the post-securitisation RWEA).

### Assessment of structural features

329. Certain structural features of the transaction may cast doubt on the extent of risk transfer and, particularly, on the sustainability of risk transfer through the life of the transaction. The EBA Guidelines specify that competent authorities should assess if there are any structural features in a transaction which might undermine the claimed credit risk transfer to third parties, which in case of traditional securitisations increase the likelihood that assets will be brought back onto the originator's balance sheet, or in case of synthetic securitisation, increase the likelihood that the credit protection will be terminated before the transaction's maturity.

### Amortisation structure

#### Regulatory framework:

330. The CRR prescribes additional own funds requirements that apply under Article 256 CRR in case of early amortisation, for securitisations of revolving exposures. This is to reflect the risk that the levels of credit risk to which the originator is exposed may increase following the activation of the early amortisation provision.
331. Neither the CRR, nor the EBA Guidelines prescribe rules on the type of amortisation in securitisation transactions.

#### Assessment:

332. There are differences across the EU in how competent authorities assess the amortisation structure in relation to SRT. Some competent authorities consider the impact of pro-rata amortisation of tranches as part of the SRT assessment, for various risks including the risk of potentially reducing the actual credit risk transferred. General concerns in relation to pro-rata amortisation relate to the decrease of value and amount of protection over time and the increase in exposure of senior retained tranches to back ended losses (i.e. losses

expected to be materialised towards the end of the underlying exposures' tenor). Other authorities also take the amortisation of notes into account in the assessment of SRT, however more flexibility is generally shown with respect to the structures involving the pro-rata amortisation.

333. In some jurisdictions, SRT is not recognised where, in synthetic securitisation transactions, the tranche(s) subject to credit protection can amortise at a faster pace than the pool of securitised exposures, taking into account the diminishing quantum of protection over time (e.g. the protection may amortise prior to defaults occurring). It is also expected that the amortisation of the first loss tranche over the life of the transaction should not lead to situations where the EL on the outstanding portfolio will not be covered by the first loss tranche.
334. In other jurisdictions, the amortisation structure is assessed specifically for its impact on portfolio loss and risk transfer, whereby portfolio composition is a key consideration. When assessing pro-rata amortisation, the following elements are considered: (i) the impact of back-loaded losses on the distribution of losses between protected tranche and retained tranches, (ii) the appropriateness of triggers that cause switch from pro-rata to sequential amortisation; and (iii) the impact on the lifetime payment to investors, particularly in the context of de-leveraging of investors.

### Call options

#### Regulatory framework:

335. The EU provisions on call options within securitisation transactions distinguish: (i) call options granted to originators vs. (put) options granted to investors/credit protection providers; (ii) call options within traditional vs. synthetic transactions.
336. The CRR specifies requirements for the clean-up call options for originators for both traditional and synthetic securitisation (in Art. 243(5)(f), and Art. 244(5)(f)), and sets out provisions in relation to time calls in case of traditional securitisations (in Art. 243(5)(d)).
337. Other relevant provisions in the CRR include:
  - a. The requirement (applicable to both traditional and synthetic securitisations) that any purchase or repurchase of securitisation positions by the originator or sponsor beyond its contractual obligations is exceptional and may only be made at arms' lengths conditions (Art. 243(4)(e)(iii), 244(5)(e)).
  - b. As for the synthetic securitisations, a set of conditions for the instruments used to transfer credit risk (Art. 244(5)(c)), rules on the maturity of credit protection (Art. 238 CRR) and treatment of maturity mismatches (Art. 250 CRR).

338. The EBA Guidelines set out additional conditions on call options for originators and options for investors, for traditional/synthetic securitisation, in more detail.
339. As regards the time calls specifically, the CRR requires that in case of traditional securitisations the originator does not maintain effective or indirect control over the transferred exposures (while at the same time it specifies that the right to repurchase the transferred exposures from the transferee is considered as such effective or indirect control, in Art. 243(5)(d)). As in traditional transactions the time calls allow the originator to repurchase the securitised exposures, the CRR effectively disallows the use of time calls in traditional securitisations for the purposes of achieving SRT.
340. The EBA Guidelines do not mention time calls specifically. However they specify that for traditional securitisations, only clean-up calls, regulatory and tax calls are allowed, while for synthetic securitisations the list is not limitative. Therefore, time calls in traditional securitisations are considered as detrimental to achieving an effective SRT (subject to other general requirements in the Guidelines applicable to call options), while the Guidelines provide more flexibility to competent authorities with regard to synthetic securitisations.
341. In the EBA report on synthetic securitisation issued in December 2015<sup>51</sup>, the EBA recommended that time calls in synthetic securitisations may be exercised on or after the weighted average life of the initial reference portfolio as at the closing date (additional criterion 7 for the purpose of the qualifying treatment of synthetic securitisation).

**Figure 27: EU regulatory framework for call options in securitisation transactions**

	Type of options	Treatment
<b>For originators:</b>		
<i>Traditional securitisation:</i>	All call options (excluding regulatory calls, tax calls and clean-up calls) granted to originator	EBA Guidelines: Considered <u>detrimental</u> to achieving SRT
	Clean-up call options	CRR (Art. 243(5)(f): Sets out the following conditions for the clean-up call options: <ul style="list-style-type: none"> <li>• Exercisable at the discretion of originator</li> <li>• May only be exercised when 10% or less of the original value of the exposures securitised remains unamortised</li> <li>• It is not structured to avoid allocating losses to credit enhancement positions or other positions held by investors and is not otherwise structured to provide credit enhancement.</li> </ul> EBA Guidelines: Clean-up call options considered as <u>not detrimental</u> to achieving SRT when compliant with the following conditions: <ul style="list-style-type: none"> <li>• CRR conditions in Art. 243(5)(f) (mentioned above)</li> <li>• They do not give the originator the right to repurchase from the transferee the previously transferred exposure</li> </ul>

<sup>51</sup>The report can be found at the following link: <https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-26+EBA+report+on+synthetic+securitisation.pdf>

		to realise their benefits, or oblige the originator to re-assume transferred credit risk.
	Regulatory or tax call options	<p>EBA Guidelines:</p> <p>Regulatory or tax call options considered as <u>not detrimental</u> to achieving SRT when compliant with the following conditions:</p> <ul style="list-style-type: none"> <li>• Only exercisable if there are changes to legal or regulatory framework that have an impact on the content of the contractual relationship of the respective securitisation transaction or that affect the distribution of economic benefits derived from the respective securitisation transaction by any of the parties in the transaction.</li> <li>• They do not give the originator the right to repurchase from the transferee the previously transferred exposure to realise their benefits, or oblige the originator to re-assume transferred credit risk.</li> </ul>
	Time call options	<p>CRR:</p> <p>Time calls considered as <u>detrimental</u> to achieving SRT, as Art. 243(5)(d) requires that the originator does not maintain effective or indirect control over the transferred exposures (an originator is considered to have maintained effective control over the transferred exposures if it has the right to repurchase from the transferee the previously transferred exposures in order to realise benefits or it is obligated to reassume transferred risk).</p> <p>EBA Guidelines:</p> <p>No specific wording on the time calls, time calls hence (implicitly) considered <u>detrimental</u> to achieving SRT</p>
<i>Synthetic securitisation:</i>	All call options (excluding regulatory calls, tax calls and clean-up calls)	EBA Guidelines: Need to be <u>considered</u> by the competent authorities <u>whether or not they are detrimental</u> to achieving SRT
	Regulatory calls, tax calls and clean-up calls	EBA Guidelines: Regulatory calls, tax calls and clean-up calls fulfilling the criteria described above <u>not detrimental</u> to achieving SRT, <u>no need to be considered</u> by competent authorities
	Time call options	EBA Guidelines: No specific wording on the time calls, hence need to be <u>considered</u> by the competent authorities whether or not they are detrimental to achieving SRT
<b>For investors:</b>		
<i>Traditional securitisation:</i>	All options granted to investors (excluding options only exercisable in the event of contractual breaches by the originator)	EBA Guidelines: Considered <u>detrimental</u> to achieving SRT
	Options exercisable in the event of contractual breaches by the originator	EBA Guidelines: Considered as <u>not detrimental</u> to achieving SRT. No further conditions.
<i>Synthetic securitisation:</i>	All options granted to investors/credit protection providers (excluding options only exercisable in the event of contractual breaches by the originator)	EBA Guidelines: Should be <u>assessed</u> by the competent authorities (as they may result in additional own fund requirements due to maturity mismatches determined as per Art. 250 CRR)
	Options exercisable in the event of contractual breaches by other parties involved in the transaction	EBA Guidelines: Considered as <u>not detrimental</u> to achieving the SRT when compliant with the conditions of CRR Art. 244(5)(c): The instruments used to transfer credit risk do not contain terms or conditions that:

- (i) impose significant materiality thresholds below which credit protection is deemed not to be triggered if a credit event occurs;
  - (ii) allow for the termination of the protection due to deterioration of the credit quality of the underlying exposures;
  - (iii) other than in the case of early amortisation provisions, require positions in the securitisation to be improved by the originator;
  - (iv) increase the institution's cost of credit protection or the yield payable to holders of positions in the securitisation in response to a deterioration in the credit quality of the underlying pool.
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**Assessment:**

342. Supervisory practices regarding the use of call options differ at least with regard to:
- a. The requirements on the originator to notify the competent authority of the exercise of call options (in particular as regards the conditions and timings of the notification);
  - b. The assessment of regulatory call options;
  - c. The assessment of time calls.
343. In relation to call options hindering SRT, jurisdictions generally consider in their assessments all the other discretionary options not specified in the EBA Guidelines, as they may potentially compromise SRT.
344. As regards the procedural aspects, it is a general practice that the exercise of a call does not need to be approved. Practices however differ as regards the requirements for the originators to notify the competent authority of the exercise of the call options, with some jurisdictions where notification is not required, and other jurisdictions where the notification is compulsory. In the latter case, the notification may be requested before the exercise of the call, after the exercise of the call within a specified timeframe (such as 15 days), or as part of the capital planning and management. In some jurisdictions, competent authorities may require that the notification contains and specifies additional explanations such as a demonstration of the fulfilment of the conditions for exercising the call option, an analysis of the impact of exercising the call option on the originator's capital ratios, and an explanation of how follow-up collateralisation is ensured.
345. Differences have also been observed with regard to regulatory call options, in particular as regards the scope of the allowed calls. While some competent authorities only allow regulatory calls exercisable when the regulatory change has a direct material impact on the efficiency of the trade of the originator (e.g. excluding calls triggered by changes in accounting regulations/standards or changes in methodologies of credit rating agencies), other competent authorities consider regulatory calls to have a wider scope.
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346. Different supervisory approaches exist also with respect to time calls. While time calls in traditional securitisation are generally considered as impediments to the achievement of SRT, they may be allowed in some jurisdictions under certain circumstances for synthetic securitisation. Differences also exist with respect to supervisory expectations on the timing of the time calls (i.e. when the time calls can be exercised). While some competent authorities require that the timing refers to the weighted average life of the securitised exposures (at the end of any applicable replenishment period), others require the maturity of the transaction to be treated as the earliest date on which the call may be exercised.
347. In the case of time calls in synthetic securitisations, supervisory assessments focus in particular on the following elements:
- a. Whether the time calls have the effect of creating maturity mismatches between the securitised exposures and the protection received (Art. 250 CRR and Art. 238(2) of CRR);
  - b. Whether there are incentives for the originators to exercise the call option or lead investors to assume that the option will be exercised, such as, the transaction contains a condition that the call option which may be exercised less than once a year (e.g. with a time window during which a call may be made); the transaction contains provisions which raise the agreed costs of protection after a certain point in time (e.g. step-up clauses); it contains terms, such as payments at maturity or payments upon early termination or significant premiums; there are pre-agreed mechanisms, for example at-market unwinds, where the protection seller and protection buyer agree that the transaction can be terminated in the future at a market value and specifies aspects of how the value is calculated;
  - c. The level of credit risk the institution would be exposed to beyond the optional call date (e.g. WAL and cumulative default rate of the assets versus the optional call date);
  - d. Whether all previous time calls have been repeatedly exercised for similar transactions.
348. In addition, in one jurisdiction it is explicitly specified that the time calls to be exercised with prior supervisory approval shall be viewed as not preventing SRT.
349. With respect to the other call options of originators, some frameworks go beyond the EBA guidance in some aspects. For example, in one jurisdiction, in the case of traditional securitisations, all call options are considered to make the transfer of credit risk ineffective: this is with the exception of regulatory calls, tax calls, clean-up calls as specified in the EBA Guidelines, but also with the exception of legal calls and calls due to breach of contractual obligations. In case of synthetic securitisations, no call options are considered to hinder the effective risk transfer but certain call options may lead to maturity mismatches. As regards

the options for investors, the supervisory frameworks are generally aligned with the EBA Guidelines.

## Excess spread

### Regulatory framework:

350. The CRR (Art. 242(1)) defines excess spread in the context of securitisation transactions as illustrated in Box 55 below.

#### Box 5: CRR definition of excess spread – Art. 242(1)

*‘Excess spread’ means finance charge collections and other fee income received in respect of the securitised exposures net of costs and expenses’*

351. Article 32 of the CRR provides requirements on the own funds treatment of ‘future margin income’ arising from the securitised assets. In relation to those provisions, the EBA RTS on the gain on sale<sup>52</sup> specify that future margin income should be intended to refer to future excess spread in the context of securitisation transactions. Article 32 of the CRR (see Box 66 for the text of the Article) provides that own funds shall not include any increase in equity arising from:

- a. Future excess spread on the securitised portfolio that results in a gain on sale;
- b. Net gains arising for the originator from the capitalisation of future excess spread from the securitised assets that provide credit enhancement to positions in the securitisation.

#### Box 6: CRR Art. 32(1)

*An institution shall exclude from any element of own funds any increase in its equity under the applicable accounting framework that results from securitised assets, including the following:*

- a) *Such an increase associated with future margin income that results in a gain on sale for the institution;*
- b) *Where the institution is the originator of a securitisation, net gains that arise from the capitalisation of future income from the securitised assets that provide credit enhancement to positions in the securitisation.*

352. Article 262(1) of the CRR provides that capitalised future income (i.e. future excess spread) cannot be considered when calculating the credit enhancement level of an unrated securitisation position, measured in terms of tranches subordinated to the position in question, for the purposes of using the Supervisory Formula Approach.

353. The amendment to the CRR accompanying the STS securitisation reform further specifies the treatment of unfunded reserve accounts, as reported in Box 77 below. The Basel securitisation standards, as revised in December 2014 and July 2016, clarify that unfunded reserve accounts are also those to be funded with unrealised (i.e. future) excess spread<sup>53</sup>.

<sup>52</sup>EBA Regulatory Technical Standards on the concept of Gain on Sale associated with future margin income in a securitisation context under Article 32(2) of CRR

<sup>53</sup> Paragraph 55 of the Basel III Revision to the Securitisation Framework (Dec 2014, revised Jul 2016) states: ‘Unfunded reserve accounts, such as those to be funded from future receipts from the underlying exposures (e.g. unrealised

**Box 7: Art. 256(4) of the CRR amendment accompanying the new Securitisation Regulation**

*‘For the purposes of paragraphs 1 and 2 [calculation of attachment and detachment point], institutions shall disregard unfunded reserve accounts and assets that do not provide credit enhancement, such as those that only provide liquidity support, currency or interest rate swaps and cash collateral accounts related to those positions in the securitisation. For funded reserve accounts and assets providing credit enhancement, the institution shall only treat as securitisation positions the part of those accounts or assets that are loss-absorbing’.*

354. Independently from the SRT-relevant requirements, CRR also refers to excess spread in relation to securitisation of revolving exposures with early amortisation provisions, and sets out additional own funds requirements for such exposures under the Standardised Approach, to address the risks associated with such type of securitisation transactions (Art. 256).
355. The EBA Guidelines specify that excess spread should be taken into account when assessing the institution’s reasoned estimate of EL on the securitised exposures (in accordance with Art. 243(2)(b) or 244(2)(b) of CRR).

**Assessment:**

356. Significant differences have been observed in the supervisory approaches to the assessment of excess spread. Differences exist in particular with respect to:
- a. Comprehensiveness of policies for the assessment of the excess spread: while some competent authorities have detailed policies in place for the consideration of the excess spread, others either have no specific methodology or the policies are principle-based;
  - b. Differentiation of the assessment of excess spread between synthetic and traditional transactions: while some competent authorities consider the excess spread both in true sale and synthetic transactions as potentially relevant for SRT, other competent authorities focus on excess spread in synthetic transactions;
  - c. Assessment of the excess spread in synthetic securitisation: some competent authorities tend to consider the excess spread as systematically hindering the achievement of the SRT, while other competent authorities take a case-by-case approach;
  - d. Regulatory capital treatment of excess spread: some competent authorities require that excess spread be subject to a 1250% risk weight/CET 1 deduction, similarly to a junior (first loss) securitisation position;
  - e. General supervisory expectations on the design and use of excess spread.

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excess spread) and assets that do not provide credit enhancement like pure liquidity support, currency or interest-rate swaps, or cash collateral accounts related to these instruments must not be included in the above calculation of A and D’.

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357. With respect to the latter, following are examples of practices that have been observed in different jurisdictions:

- a. It is expected that the excess spread is considered as an additional first loss tranche/expected loss retained by the originator, and as such considered in the SRT quantitative tests and/or the calculation of own funds requirements post-securitisation. It is also expected that the impact of excess spread is factored into the assessment of the costs of protection.
- b. As regards the focus of supervisory assessment, consideration may be given to the following aspects:
  - i. Position of excess spread in the payment waterfall;
  - ii. Use of excess spread to cure previous losses suffered by the credit protection provider;
  - iii. Capacity of the securitised portfolio to generate excess spread across scenarios, throughout the life of the transaction (as a result of prepayments, substitutions, delinquencies, defaults);
  - iv. Allocation mechanism of the excess spread, typically taking the form of either a 'use-it-or-lose-it' mechanism or a 'trap' mechanism;
  - v. The presence of swaps providing a guaranteed level of excess spread;
  - vi. The interaction between the use of excess spread and the potential scenario of high costs of credit protection.
- c. As regards the computation of excess spread, consideration may be given to the appropriateness of the time period over which the present value is determined, while it should not be less than one year, or the remaining life of the transaction, whichever is shorter. The calculation may be based on lifetime UL (when the excess spread is defined on actual final losses) or cash flow projections provided by the originator (when the excess spread is defined based on the actual margin income and principal payments over a pre-determined period (e.g. quarterly, semi-annually)). It may also be based on an assessment of the effective credit enhancement provided by the excess spread to third party investors.

### Cost of credit protection (synthetic securitisation)

#### Regulatory framework:

358. The CRR specifies that the derivative or guarantee that is used to transfer the risk does not contain terms or conditions that increase the institution's cost of credit protection or the

yield payable to holders of positions in the securitisation in response to a deterioration in the credit quality of the underlying pool (Art. 244(5)(c)(iv) of CRR).

359. The EBA Guidelines specify that if premiums paid to the credit protection provider are not recognised in the profit and loss account of the originator, competent authorities should consider whether premiums paid are excessively high to the extent that SRT will be undermined. This could be assessed in a number of ways such as by looking at the premiums paid compared to (i) the yield of the asset pool, (ii) the losses being covered by the protection, (iii) fair market rates, or (iv) some combination of these various factors. Competent authorities should also consider whether there are other features of the transaction outside the premiums, such as fees, which effectively increase the cost of the protection being provided to the extent that credit risk transfer will be undermined.
360. The Guidelines also require that where premiums are paid up-front, or are not linked to losses in the asset pool being protected or otherwise guaranteed, competent authorities should consider if this reduces the extent of credit risk transfer.

**Assessment:**

361. Some consistency has been observed among the individual supervisory frameworks with respect to the cost of protection, which generally intend to focus on the assessment of appropriateness of the cost of credit protection (for the purpose of determining potential high cost of credit protection), and on protection payments structured to be paid on a non-contingent and up-front basis. Important differences however exist in the comprehensiveness of the policies, and factors considered, when assessing whether the credit protection payments constitute high cost of credit protection, and how other structural features of the transactions (such as excess spread) are considered in such assessment.
362. Examples of aspects considered by competent authorities when determining whether the cost of protection is appropriate or excessive include the following:
- a. Comparison of the cost of protection with various factors such as expected payments under the protection (on the basis of the protected portion of the portfolio's EL and UL) and spread income on the portfolio;
  - b. Whether the premium is risk based, as premiums which are guaranteed in almost all circumstances (e.g. it is payable upfront, even when it is deducted from capital) may have an impact on the extent of risk transfer;
  - c. Whether the premium is high or not, relative to the amount of the exposures being protected;
  - d. Whether the transaction exhibits structural features that can increase the total cost of credit risk protection, such as excess spread;

- e. Whether the originator can prudently afford the premiums given its earnings, capital and overall financial condition.
363. In one jurisdiction, the cost of credit protection is considered not to prevent SRT as long as the originator can demonstrate that the expected future costs associated with a transaction are below the expected future income of the underlying portfolio or are deducted from own funds. In assessing the expected future costs, specific aspects of the transaction are considered such as hedging of the premiums or the excess spread.
364. Timing of the cost of protection payments also plays a role in the supervisory assessment. Specific focus is generally on premiums paid up-front, which may have a significant impact on the extent of risk transfer and where it is expected that the originator deducts such premiums from capital.
365. The calculation of the credit protection payments is also an important consideration in the SRT assessments. When considering the appropriateness of the calculation method, it is checked, in particular, whether the premium is linked to the protected tranche thickness. For instance, linking the premium to the entire pool of securitised exposures may not be allowed, in order to prevent that the protection payments keep being made after the tranche on which protection has been purchased has been exhausted.

### Other early termination events (for synthetic securitisations)

#### **Regulatory framework:**

366. There is no specific regulatory framework on early termination of credit protection contracts in the CRR securitisation framework, nor within the EBA Guidelines.

#### **Assessment:**

367. Despite the standard market practice to include the bankruptcy of the protection buyer as an early termination event (i.e. allowing the protection provider to terminate the contract upon the bankruptcy of the originator), no systematic approach to this clause exists in a number of jurisdictions in relation to SRT.
368. When systematic approaches exist, practices differ, with some competent authorities considering these clauses as hindering SRT, as they undermine the use of credit protection when this is most needed, and other competent authorities considering the ISDA bankruptcy termination clauses as generally acceptable for the purposes of SRT.
369. As regards the other prevalent types of early termination events (such as failure to pay, breach of material contractual obligations, illegality arising from a contractual obligation, and servicing event), these are normally not considered as detrimental to the achievement of SRT, and no material differences have been observed in the supervisory approaches across jurisdictions.

## Credit events (for synthetic securitisations)

### Regulatory framework:

370. Credit events are those events that trigger credit protection payments from the protection seller to the protection buyer within a credit protection contract. The CRR includes the following credit events:
- a. In Art. 178 CRR, it provides the definition of default or the counterparty/borrower (the obligor is unlikely to pay, or past due more than 90 days<sup>54</sup>);
  - b. In Art. 216(1)(a), it specifies credit events that must be included in order for a credit derivative to be eligible as unfunded credit protection. These include: (i) the failure to pay the amounts due under the terms of the underlying obligation that are in effect at the time of such failure, with a grace period that is equal to or shorter than the grace period in the underlying obligation; (ii) the bankruptcy, insolvency or inability of the obligor to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and analogous events; (iii) the restructuring of the underlying obligation involving forgiveness or postponement of principal, interest or fees that results in a credit loss event.
371. Furthermore, in case the definition of contractual credit events of a credit derivative used for synthetic risk transfer does not include restructuring of the underlying obligation, only a part of the protection amount can be recognised as protection (Article 216(1) last subparagraph CRR).
372. The EBA report on synthetic securitisation (2015) indicates those credit events that, as a minimum, should be included credit protection contracts, including: (i) failure to pay after 90 days, (ii) restructuring and (iii) bankruptcy of the obligor. The EBA Guidelines require competent authorities to consider the credit events that are covered by the credit protection obtained as part of their assessment (including whether it includes the standard credit events as mentioned above).

### Assessment:

373. As a general rule, the definition of contractual credit events plays a role in the comprehensive assessment. Reference is given to the relevant CRR provisions and EBA Guidelines. It is generally expected that the transaction documentation should, as a minimum, cover default pursuant to Article 178 CRR, and, where credit derivatives are used to transfer credit risk to third parties, credit events specified in Art. 216(1).

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<sup>54</sup> The threshold may be 180 days in specific cases.

## Replenishment mechanisms

### Regulatory framework:

374. There are no specific provisions in the CRR with regard to the assessment of SRT on the replenishment of the securitised portfolio. The EBA Guidelines suggest that, where transactions include replenishment periods, competent authorities should consider the following elements: (i) the eligibility criteria of the assets in the underlying pool; and (ii) the minimum and maximum credit quality of eligible assets.

### Assessment:

375. Competent authorities generally assess the replenishment mechanisms in relation to SRT. General supervisory expectations are that the replenishment criteria allow maintaining the credit quality of the pool. Criteria that enable the originator to support the transaction in favor of investors and substantially improve/deteriorate the credit quality are considered as potentially compromising SRT. Competent authorities also assess the impact of the replenishment period on the weighted average maturity of the securitised assets. In some jurisdictions, institutions are in addition expected to provide an assessment of portfolio migration risk for structures with replenishment conditions.

## Substitution/reinvestment of assets

### Regulatory framework:

376. There are no rules in the CRR on the substitution/reinvestment of assets. The EBA Guidelines suggest considering if the assets can be substituted into the structure with the view to protecting investors from losses while increasing credit risk to the originator, thus preventing an effective risk transfer.

### Assessment:

377. The substitution/reinvestment of assets is generally considered by competent authorities as a critical aspect and a condition limiting the effective credit risk transfer. Assessments normally focus on the impact of the substitution/reinvestment of assets on the credit quality of the securitised portfolio, including the occurrence of concentration risk and the presence of practices of implicit support.

378. Some jurisdictions have a detailed framework in place on the assessment of substitution/reinvestment of assets. If substitution and/or reinvestment of assets is permitted, factors assessed, both at inception and on an on-going basis, include for example whether the portfolio quality can be managed over time such that less risk is transferred and investors are protected from incurring losses, how substitution/reinvestment may affect the concentration of the underlying portfolio, and



whether maturity and/or currency mismatch may be affected by the substitution and/or reinvestment of assets.

### Repurchase transactions by the originator

#### Regulatory framework:

379. Art. 243(5)(d) of CRR, applicable to traditional transactions, requires that *'the originator does not maintain effective control over the transferred exposures. An originator shall be considered to have maintained effective control over the transferred exposures if it has the right to repurchase from the transferee the previously transferred exposures in order to realise their benefit or if it is obligated to re-assume transferred risk. Servicing rights or obligations shall not of themselves be considered as an indirect control'*.
380. As for the synthetic transactions, Art. 244(5)(e) of CRR prescribes that *'any purchase or repurchase of securitisation positions by the originator beyond its contractual obligations may only be made at arms' lengths conditions'*.
381. The EBA Guidelines suggest that the competent authorities should consider if the originator has in the past repurchased transactions to protect investors and if the rules on implicit support, as specified in Article 248 of CRR, have been followed by the originator in the past, so as to minimise the risk that the credit risk has not been effectively transferred.

#### Assessment:

382. The supervisory assessment of repurchase transactions by originators generally focuses on whether under the contractual agreement the originator does not maintain effective control over the transferred exposures (Art. 243(5) of the CRR), as well as on whether the repurchase transaction taking place under a non-contractual agreement might constitute an implicit support (Art. 248 of the CRR). Repurchase transactions are generally considered as conditions potentially hindering the effective credit risk transfer.
383. Certain national frameworks in addition specify that, in case of traditional securitisations, repurchase of loans due to ineligibility/breach of representations and warranties may be acceptable as long as there is a clearly documented process for replacement. Consideration in this case is given to the following: (i) the likelihood of the originator having to repurchase loans due to breach of representations and warranties; (ii) the impact on capital of such repurchases; (iii) whether a capital buffer is required for this risk. The assessments also focus on repurchase conditions (quantum, timing and pricing), as well as on how fair market value is determined.

## Discounted asset sales

### Regulatory framework:

384. There is no specific regulatory treatment of discounted assets sales in the SRT framework of the CRR, nor in the EBA Guidelines.

### Assessment:

385. Discounted asset sales are generally assessed in relation to SRT and compared to their economic value. The assessment may in addition focus on (i) whether the originator has sold the assets to the SSPE at a suitable price representing their true economic value: an excessive discount granted to the Securitisation Special Purpose Entity (SSPE) would pose a concern if it were not be recognised as additional effective credit enhancement; (ii) whether the originator has recognised the sale of the assets at a discount in their analysis; and (iii) what is the effective coupon on the tranches which the originator is not retaining.

## Maturity mismatches

### Regulatory treatment:

386. The CRR requires maturity to be assessed in considering SRT for synthetic securitisation. It sets out detailed requirements in relation to maturity mismatches, including requirements to reflect the maturity mismatches in the value of the credit protection (the calculations are detailed in the Art. 237, 238, 239 and 250 of CRR). Also, Art. 237 sets out the types of maturity mismatches that disqualify the protection as eligible credit protection.

387. EBA Guidelines suggest that when assessing the maturity of the protection, competent authorities should consider whether call options or other features might reduce the maturity of the protection in practice, and how this relates to the expected time of defaults on the pool of securitised exposures. Furthermore, competent authorities should assess maturity mismatches for transactions where the securitised exposures are able to replenish, as originators may substitute in longer maturity assets towards the back-end of the protection period, increasing any maturity mismatch.

### Assessment:

388. The existence of maturity mismatches is considered to potentially hinder SRT. Competent authorities generally check the correct application of the necessary calculations in line with the CRR. Additional checks may be done in some jurisdictions, on the top of checking compliance with the relevant CRR articles. Examples of additional aspects considered include: (i) the payment profile of the underlying exposures i.e. whether they are amortising or bullet exposures; (ii) how the expectation of default timing compares with the maturity of the protection, and whether the defaults are expected to occur after the protection has expired; (iii) whether the maturity mismatch increases with the substitution

by new exposures or exposures with longer maturities towards the back-end of the protection period, as the expected default timing of these exposures may be after the protection expires; and (iv) whether call options or other features potentially lead to a larger maturity mismatch.

### Currency mismatches

#### Regulatory approach:

389. According to CRR, any currency mismatches should be reflected in the value of the protection. The calculation is detailed in Art. 222 and 223 (for funded credit protection) and 233 of the CRR (for unfunded credit protection).
390. According to EBA Guidelines, competent authorities should assess currency mismatches for transactions where the pool of securitised exposures contains a different currency profile than the liabilities. Where such mismatches occur, prudent haircuts should be applied to the capital relief sought in accordance with the views of the competent authorities. Mitigating instruments, such as currency swaps should be assessed for appropriateness in terms of the balance swapped, the duration of the swap itself, and any contingent triggers.

#### Assessment:

391. The supervisory assessments of currency mismatches are generally focused on checking the correct application and adjustments of the currency mismatch calculations (i.e. Art. 222, 223 and 233 of CRR). There are no systematic approaches to the assessment of currency mismatches in relation to SRT, in a number of jurisdictions. In some jurisdictions, consideration is given to whether the currency mismatches can increase with asset substitution and/or reinvestment, and whether the currency risk could lead to the originator needing to assume risk back on balance sheet under certain circumstances.

### Other aspects considered by competent authorities as part of the comprehensive assessment

#### Additional internal quantitative formulas to evidence commensurate transfer of risk

#### Regulatory framework:

392. The EBA Guidelines specify further the factors that should be considered when assessing the commensurateness of the credit risk transferred, in particular:
  - a. Comparison of the RWEA (and as relevant expected loss amounts) before securitisation (on the securitised exposures) and after securitisation (on the tranches retained); and

- b. The methods used to demonstrate the credit risk transfer in case of application of the permission-based SRT.

**Assessment:**

393. A number of competent authorities require originators to provide additional demonstrations to evidence that commensurate credit risk has been transferred. Practices differ in the factors which the individual competent authorities focus on for their assessment. Among the factors considered:

- a. Assessment of the capital savings post securitisation;
- b. Application of specific formulae to assess that risk transfer is commensurate: for example by comparing the relative reduction in risk-weighted asset amounts achieved by the originator as a result of the transaction and the share of total risk on the portfolio that is transferred to third parties; or, by ensuring that a minimum percentage ratio of mezzanine tranches or of the UL on the underlying exposures is transferred (requiring, for example, a transfer of at least 50% of the UL on the underlying pool of exposures).

### Supervisory Formula Method (SFM)

**Regulatory framework:**

394. The EBA Guidelines specify that in case of the use of SFM, competent authorities should consider how sensitive the capital requirement on the originator's retained securitisation positions are to changes in the underlying IRB parameters. The EBA Guidelines suggest that if the own funds requirements on the retained positions are highly sensitive to small changes in these parameters, it is less likely that commensurate credit risk has been transferred.

**Assessment:**

395. Most Competent authorities check the correctness of the calculation and inputs of the SFM, as well as the sensitivity of own funds requirements to changes in the values of the IRB parameters. In one jurisdiction, the CA is generally more skeptical of the achievement of commensurate risk transfer for transactions where the regulatory capital calculation used produces very low own funds requirements.

### External IRB models

**Regulatory framework:**

396. The EBA Guidelines require that where external models have been used, competent authorities should assess whether these models have been integrated into the originator's

regular processes, and whether the originator has an appropriate understanding of how the model operates and of its underlying assumptions.

**Assessment:**

397. Generally, both external and internal IRB models are allowed for the purposes of achieving SRT. As for the external models, the competent authority needs to understand whether the originator has sufficient knowledge and understanding of the model, whether these models have been integrated into the originator's regular processes and the models' underlying assumptions. In one jurisdiction, external models are allowed if they are also used for internal risk management purposes by the institution.

**Transaction information/documentation**

**Regulatory framework:**

398. The CRR requires that the securitisation documentation reflects the economic substance of the transaction for all transactions seeking SRT recognition. The EBA Guidelines also require the competent authority to assess the documentation and evidence provided by the originator, indicating some factors to which the CA should pay particular attention.

**Assessment:**

399. Competent authorities generally require, or invite, the originator to provide a comprehensive and detailed set of information and documentation in order to carry out the comprehensive assessment of SRT.
400. The required information normally includes detailed information on the transaction, securitised exposures, securitised positions, information on the risks transferred and retained, as well as other aspects of the transaction, to enable detailed analysis of the transaction and of the compliance with the requirements in Art. 243 and 244 of CRR. In many jurisdictions, the information needs to be supported by additional supportive documents, e.g. an opinion from the management regarding the SRT, contractual documents, legal opinions, etc.
401. In a majority of jurisdictions, the required information/documentation change either based on (i) whether the securitisation is traditional or synthetic, with additional information generally requested for synthetic securitisation, or (ii) whether the SRT recognition is based on quantitative SRT test (CRR Art. 243(2)/244(2)) or it is permission-based (CRR Art. 243(4)/244(4)), whereby additional information requirements generally apply to permission-based SRT transactions.

## Funded vs unfunded credit protection

### Regulatory treatment:

402. If an institution is seeking to obtain capital relief, the credit protection needs to comply with the credit risk mitigation rules laid down in Part Three, Title II, Chapter 4 of the CRR. According to Art. 247 of the CRR, institutions may recognise funded or unfunded credit protection in respect of a securitisation position as a credit risk mitigation technique for the purposes of calculating the RWEA of the protected tranche. The CRR then prescribes detailed rules, specific for funded/unfunded credit protection, to be eligible.
403. In the EBA Guidelines, it is required that where the securitisation is of the synthetic type, competent authorities should ensure that the credit protection provides sufficient certainty of payment so as not to undermine the credit risk transfer. If the credit protection is funded, collateral arrangements should be assessed. If the credit protection is unfunded, competent authorities should consider whether suitable arrangements are in place to ensure timely payments.

### Assessment:

404. In a number of jurisdictions, the type of the transaction (i.e. funded or unfunded type of the protection) plays a role in the comprehensive assessment. Competent authorities generally apply different approaches depending on whether the protection is funded or unfunded, reflecting differences in CRR rules, while national frameworks also prescribe additional different requirements.
405. In one jurisdiction, the distinction between funded and unfunded credit protection generally does not play a role in the quantitative SRT assessment.

## Accounting treatment

### Regulatory framework:

406. There are no specific provisions on the accounting treatment of securitisation transactions in the CRR nor in the EBA Guidelines.

### Assessment:

407. In a majority of jurisdictions, the accounting treatment is given some consideration the SRT assessment, although the comprehensiveness of individual supervisory approaches differ. Competent authorities focus on the interactions of the accounting treatment with the regulatory capital treatment, and the possibility of arbitrage arising in between the two is generally considered.
408. Where more comprehensive policies for the evaluation of the accounting treatment exist, they focus on the following aspects:

- a. Interactions and possible arbitrage between the accounting and regulatory capital treatment. For instance, it is assessed whether the originator is accounting for the cost of protection, or loss on sale of assets to the SSPE, on an amortised basis whilst taking regulatory benefit up front; or whether the originator re-values any assets or moves them from one accounting method (e.g. carrying amount) to another (e.g. market value), and what is the impact on the originator's P&L;
  - b. Choice of accounting methods for the securitised exposures and the protection bought and whether they do not lead to maturity mismatches;
  - c. Whether the institution is accounting for the credit protection agreement in the form of a derivative or a guarantee, and whether this is in line with the contractual documentation.
409. In some jurisdictions, an analysis is requested from the official auditor regarding the accounting treatment of the transaction.

### Securitisation of non-performing loans (NPLs)

#### **Regulatory treatment:**

410. There is no specific treatment in the CRR/EBA Guidelines on the SRT assessment of NPL securitisations.

#### **Assessment:**

411. The assessment of transactions collateralised by NPLs does generally not differ from the assessment of other SRT transactions. General discounted asset sale considerations apply, i.e. transactions collateralised by NPLs should be treated as any other purchase price discount or any other kind of over-collateralisation.
412. In one jurisdiction, the framework requires to consider as part of the SRT assessment whether the originator has the discretion to remove bad loans and receivables from the pool and replacing these with better or worse quality loans. Competent authorities in two jurisdictions confirmed that there have been no SRT transactions in the past exclusively securitising NPLs.

### Knowledge of underlying exposures

#### **Regulatory framework:**

413. The EBA Guidelines specify that competent authorities should consider whether the originator has sufficient knowledge of the underlying assets.

**Assessment:**

414. Competent authorities assess the originator's knowledge of underlying exposures. Some competent authorities assess this indirectly, in particular through information provided by the originator on the underlying exposures, and on compliance with credit granting criteria. Other competent authorities evaluate whether the institution has appropriate internal policies for own SRT assessment, and check the institution's knowledge of underlying exposures and ability to use methodologies for SRT. The assessment may in addition focus on assets and their origination, risk management policies and procedures, loss history, governance around the SRT assessment, as well as institutions' historical experience with relevant securitisation origination.

**Connections between originator and third parties****Regulatory framework:**

415. The CRR requires that risk be transferred to third parties and sets out specific requirements in this regard. The EBA Guidelines provide that competent authorities should assess whether significant credit risk is transferred to third parties who are not connected to the originator in a manner that might undermine the credit risk transfer. Competent authorities should consider any relevant connection between the investors or credit protection providers and the originator, and whether the originator provides the third parties with significant financing when conducting their SRT assessment.

**Assessment:**

416. Competent authorities generally assess whether there are any relevant connections between the originator and the party to which the credit risk is transferred, in view of ensuring that credit risk is transferred to a non-connected entity so as not to undermine the effective credit risk transfer. Various factors are considered in this regard in different jurisdictions:

- a. Consideration whether the third party does not belong to the consolidated group of the originator;
- b. Consideration of significant legal, operational and economic dependencies;
- c. Consideration of the absolute and relative size of the total exposure of the originator towards potential investors;
- d. Consideration of whether the securities issued do not represent payment obligations of the originator (CRR Art. 243(5)). The framework specifies that the securities shall not contain any explicit or implicit recourse to the originator for bondholders, including committed or uncommitted liquidity support, as well as obligations or options to buy the securities issued from bondholders. The originator



shall however not be prevented from buying from time to time some securities for market-making purposes;

- e. Consideration as to whether the investors have close links with the originator (as defined in Article 4(1) point (38) CRR);
- f. Consideration of whether securitisation positions are offered to professional investors, in which case it is required by law that the information sheet shall indicate any existing participation linkages between the originator and the transferee.

### Internal policies for assessing transfer of credit risk and SRT

#### Regulatory framework:

- 417. The CRR makes reference to internal policies with respect to transactions to which permission-based tests apply and requires that such transactions must meet all of the following conditions: (i) the institution has appropriately risk-sensitive policies and methodologies in place to assess the transfer of risk; (ii) the institution has also recognised the transfer of credit risk to third parties in each case for the purposes of the institution's internal risk management and its internal capital allocation.
- 418. According to the EBA Guidelines, competent authorities should consider whether the originator has appropriate internal policies for making its own SRT assessment. This should include not only an initial assessment of the transaction when the originator is first seeking the exclusion of securitised exposures from the calculation of RWEAs and, as relevant, expected loss amounts, but should also consider the ongoing assessment of SRT during the life of the transaction.

#### Assessment:

- 419. Competent authorities generally assess the originator's internal policies, experience and expertise to make its own SRT assessment, on the basis of information and documentation provided by the institution in relation to the SRT transaction. As part of the assessment, the competent authorities can consider governance policies with respect to securitisation issuance and SRT, supervisory track records concerning the originator, the credit granting policy of the originator or independent legal opinions on the securitisation structure. Ongoing access to data on the underlying assets, and the ability of the originator to maintain an adequate separation of its balance sheet to take account of e.g. encumbrance, may also be taken into account. The assessment can be supplemented by on-site inspection reports where available. A majority of competent authorities require/expect appropriate engagement of senior management of the originator in execution of securitisation transactions seeking capital relief.

## Annex 2: Analysis of specific market practices in relation to SRT

### Additional aspects considered by originators as part of SRT assessment

#### Use of ratings

420. According to information gathered by the EBA, most investors active in the securitisation market (at least in the synthetic one) do not require securitisations to be rated, hence the standard market practice is that no rating is usually acquired for the securitisations.
421. The existing CRR requires that where a tranche of the securitisation is rated, or where a rating for that tranche may be inferred, the originator that is using the IRB approach is required to use that rating for the purpose of determining the risk weight for that specific tranche. This may result in less advantageous risk weights than those that would be achieved using the Supervisory Formula Method, which explains a general preference of the institutions for using the SFM.
422. Ratings may be used for determining risk weights of securitisation positions under the Standardised Approach, where the SFM is not available. However, as the regulatory capital benefits for an institution under the SA are much more limited than under the IRB approaches, only a limited number of institutions using the SA undertake the securitisation transactions.

#### Supervisory Formula Method (SFM)

423. The EBA Guidelines specify that in case of the use of SFM, competent authorities should consider how sensitive the capital requirement on the originator's retained securitisation positions are to changes in the underlying IRB parameters. A majority of institutions does perform a sensitivity analysis when using the SFM, which includes the application of small or major changes to the parameters used, such as PD, LGD,  $K_{IRB}$ , rating, effective number of exposures, WA-LGD, L and T (e.g. changes in PD and LGD from 10 to up to 15, 25 and 50%, or changes in rating of  $\pm 1/\pm 2$  notches). The ad-hoc analysis may also include other considerations, such as reduction of 1% of the attachment point (to reflect a potential loss of the tranche under analysis), extension of maturity or reduction of sales. The stress test aims to evidence sufficient resilience of the institutions' capital position to changes in the risk parameters of the underlying portfolio.
424. As regards the frequency, the stress tests may be performed either on a systematic or on an ad hoc basis and in specific circumstances (for example, when the originator transits to the use of SFM during the lifetime of the transaction, as a result of obtaining permission to use an IRB approach).

425. For a minority of transactions, no sensitivity analysis is performed. In some cases, this has been justified by the fact that external ratings are available for the senior tranches of the transactions. SFM can then be used only for calculation of the mismatch of the risk weighted amount where the RWA of the distributed tranche is an input in the relevant formulae under the CRR. One originator clarified the absence of the sensitivity analysis by application of conservative tranching (so as to ensure that the senior tranche achieves the 7 % risk weights).

### Accounting treatment

426. In case of synthetic securitisation, the accounting treatment is a core consideration for the originator when structuring the transaction, in addition to regulatory capital treatment and cost of credit protection considerations.
427. In a majority of cases, the institutions seek to apply a 'financial guarantee treatment', in which the credit protection applies as an accounting hedge for the securitised exposures, subject to compliance of the transaction with some specific features. As an alternative, 'derivative accounting' treatment can be applied according to which the institution would be required to recognise the mark-to-market value of the credit protection, which could then be offset against the securitised exposures in the institution's accounts.
428. It is possible for a credit protection arrangement to be structured in a way to be eligible for the financial guarantee treatment irrespective of whether it is documented as a guarantee, a credit default swap or a credit linked note. Similarly, not all transactions documented as a guarantee will satisfy the accounting requirements for a financial guarantee treatment. In fact, whichever form of documentation is adopted, the terms will be largely the same as far as the accounting treatment is concerned.
429. In case of traditional securitisation, the accounting rules allow the institution to de-consolidate the SSPE and achieve the accounting de-recognition of the securitised assets (subject to compliance with relevant requirements), leading to the reduction of their balance sheet. Conditions on the consolidation of the SSPE are governed by the IFRS 10. Conditions under which the originators can derecognise the securitised assets from their accounting consolidation are determined in the accounting standards (IAS 39 evolving into the newly reformed IFRS9). Besides checking that the originator has transferred the rights to receive the cash flow from the securitised assets, the accounting standards also require that the originator has transferred substantially all risks and rewards. The wording 'substantially all risks and rewards' has been interpreted by both US and EU authorities as implying 90% of the risks and rewards. The accounting derecognition is thus relatively difficult to achieve, and only a very limited number of transaction have managed to derecognise the securitised assets from their balance sheet.

### Involvement of senior management in SRT transactions

430. All originators noted that there is an active involvement of the senior management in the approval, execution and/or design of the securitisation transactions claiming SRT. Final approval is usually granted by the Board of Directors and the involvement of the senior management usually follows a predefined process and established governance policy.

### Quantitative testing of the risk transferred

#### Quantitative SRT tests (as per Art. 243(2) and 244(2) CRR)

431. The originators consistently rely on the quantitative SRT tests provided for in the CRR (as per Art. 243(2) and 244(2)), as part of their internal assessment of whether a given transaction achieves significant risk transfer to third parties. Compliance with the tests is checked throughout the lifetime of the transaction, usually on a quarterly basis and sometimes more frequently (e.g. on a monthly basis).
432. Originators generally consider the focus of the supervisory assessments on the transfer of both the regulatory and the economic risk as an adequate approach. Several originators reported a few deficiencies of the current tests (see Section 0 for further details on the quantitative tests).

#### Interpretation of the margin over expected loss in case of application of the first loss quantitative SRT test

433. For securitisation transactions without mezzanine tranches the SRT quantitative test provided for in the CRR requires that the exposure value of the securitisation positions that would be subject to CET1 deduction or 1250% risk weight exceeds by a 'substantial margin' a 'reasoned estimate' of the expected loss on the securitised exposures. Different approaches exist as to the way originators (i) compute the EL and UL on the securitised exposures; (ii) assess the substantial margin referred to in the CRR.
434. Some originators refer to the regulatory definition of EL and UL, whose calculation is based on a 1-year horizon. Some originators employ lifetime (multi-year) economic EL and UL concepts, reflecting the lifetime of the transaction, or use both 1-year and lifetime EL and UL concepts. This allows considering economic capital figures and an internal risk-based analysis as a complement to the asset level analysis.
435. There are different interpretations used for the concept of the 'substantial margin'. The focus of the assessment of the 'substantial margin' is normally on the thickness of the first loss tranche, but practices differ. Examples of approaches to assess the thickness of first loss tranche include:

- a. Assessment of the ratio of 1250% risk-weighted positions to EL;

- b. Expectation that 1250% risk-weighted positions exceed the sum of lifetime EL and 25% of lifetime UL;
  - c. Expectation that 1250% risk-weighted positions exceed the stressed EL (e.g. by a factor of between 3 and 7).
436. The assessment of the thickness of the first loss tranche can take into account specific waterfall provisions (i.e. over-collateralisation, excess spread, cash reserves, pro-rata payments, step-up clauses, credit enhancements, etc.). Some originators use historical data to analyse the relationship between losses in normal periods and stressed periods to determine the margin.

#### Permission-based SRT tests (as per Art. 243(4) and 244(4) CRR)

437. There are normally no specific tests applied by originators in case SRT is sought under CRR Art. 243(4)/244(4). Only a very limited number of institutions have developed specific tests used specifically for the transactions assessed under Art. 243(4) and 244(4).
438. One example of such test is based on a modification of the mezzanine test. The approach considers all securitisation tranches that exceed the reasoned estimate of the (multi-year) EL of the underlying exposures (i.e. any portion of any 1250% risk weighted positions is included in the interval of relevant tranches that exceeds the reasoned estimate of the EL). SRT is achieved if 50% or more of the RWA of all such relevant tranches have been sold to third parties.

#### Additional internal quantitative formulas to test the amount of the transferred risk

439. A number of originators reported using additional internal policies/quantitative formulas to test the amount of the risk transferred, in addition to the tests prescribed in the CRR. These tests are conducted ahead of the origination as well as during the lifetime of the transaction. Examples of these additional tests are provided below.

#### 440. Base case scenario quantitative tests:

- a. For the transactions without mezzanine tranches, the exposure value of the 1250% risk-weighted tranches must exceed the sum of the economic multi-year EL and 25% of the economic UL of the securitised exposures.
- b. For the transactions with mezzanine tranches, the thickness of the mezzanine tranche must be equal to or exceed: the sum of EL and 25% of UL in case there is no 1250% risk-weighted tranche, or 25% of the UL in case there are 1250% risk-weighted tranches covering the EL.
- c. For the transactions with the mezzanine tranches, the buffer - representing the sum of the risk weights of the mezzanine tranche (sold to investors) and first loss tranche (deducted from capital) – must exceed the economic capital. If the buffer is

less than the economic capital, the institution needs to demonstrate that the reduction in economic capital is proportionate to the reduction in  $K_{IRB}$  post securitisation.

- d. The 'value at risk (VaR) indicator' is higher than 50% (the VaR indicator measures the relative reduction of the credit VaR realised by the securitisation). If the VaR indicator is lower than 50% but higher than 40%, the transaction is still deemed transferring risk if the 'probability indicator' is greater than 70% (the probability indicator quantifies the probability that the loss of the retained tranches does not exceed the unexpected loss of the underlying portfolio when it is comprised between the EL and the VaR).

441. **Stress scenario tests:** It is a consistent feature to evaluate the risk transfer both in a base case as well as in a stress scenario. Different stressing methodologies are used to assess an increase in the credit risk (EL and UL) of the asset pool, testing systemic macro-economic risks as well as idiosyncratic risks independent of the economic cycle, to verify the transfer of the risk under stressed conditions and the impact on the capital, cost of protection and investors' losses.
442. **Cost of credit protection tests:** An important part of the analysis for synthetic transactions is an evaluation of the cost of protection, generally aimed to assess whether the premiums paid to the credit protection provider are commensurate to the risk transferred. Different metrics are used for this purpose, including, comparing the premium with protected losses and protection benefit received under various loss scenarios including stress scenarios, with the yield of the asset pool, the percentage of placement to investors, and market prices. Considerations are made both for a base case and stress scenario.
443. Institutions also assess a wide area of other qualitative features of the transactions as part of their internal assessment. Both regulatory and economic risk transfer are normally assessed in all these additional tests. The objective of the assessment is to check the robustness of the securitisation structure to ensure the stability of own funds requirements on the retained positions, of capital savings as well as of credit risk transfer.

## Annex 3: Additional data on the SRT transactions

444. The following section provides further information on specific characteristics of the notified SRT transactions, building on the data reported in the SRT notifications according to the EBA Guidelines, such as on the capital structure of the transactions, efficiency of capital reduction.

### Efficiency of the capital reduction achieved

445. The analysis of the capital reduction achieved through securitisation (based on comparison of the capital reduction achieved and capital reduction claimed) shows that in a majority of cases (30 transactions), the capital reduction achieved has been lower than initially claimed by the originators. It is understood that competent authorities consistently adjust the amount of the capital relief claimed by the originator based on the comprehensive assessment of the transaction.

446. In 11 cases, institutions achieved the capital reduction as they claimed in their SRT notifications (or the difference between the capital reduction claimed and achieved has only been marginal e.g. there has been one percentage point difference). In case of few transactions, the capital reduction achieved has been actually higher than claimed by the originator. This mostly reflects the inconsistencies in the originators' individual interpretations and calculations used for determining the amount of the capital relief claimed. In other cases, no data have been provided in the amount of the capital reduction claimed.

447. The capital reduction achieved ranges from 35 to 100%, while the average amount is 71.1%. The capital reduction claimed ranges from 0 to 100%, while the average amount is 77.4%.

### Amount of risk transferred to third parties

448. The analysis of the amount of the risk transferred to third parties (based on attachment and detachment point of the risk sold, irrespective of the capital structure of the transaction) shows that a substantial part of the risk has been transferred to third parties, for a majority of traditional securitisations (in case of 6 transactions, the amount of the risk transferred was between 95 to 100%). The average amount of the risk transferred is 57.3% for traditional securitisations and 7% for synthetic securitisations.

### Capital structure of the SRT transactions

449. As regards the first loss tranche:

- a. In 20 transactions, the whole first loss tranche has been retained by the originators.
- b. In 17 transactions, the whole first lost tranche has been sold to investors (this includes one transaction where the first loss tranche has been considered

mezzanine tranche according to Art. 244(3) CRR for the purpose of the SRT assessment).

- c. In 12 transactions, the percentage of the first loss tranche retained ranges from 5 to 20%.

450. As regards the mezzanine tranche:

- a. A minority of transactions (11) have no mezzanine tranche, in which case a maximum of 20% of the first loss has been retained by the originators (so as to meet the first loss SRT test).
- b. For the transactions that have no mezzanine tranche (and have been subject to the first loss SRT test), the 1250% tranche covers both the EL and the UL. The EL is 0.4%, the EL + UL is 5.1% and the thickness of the 1250% tranche is 7.6%, on average for these transactions. This shows that the 'margin' applied for these transactions is 7.2% between the EL and the detachment of the 1250% tranche (and 2.5% between the EL + UL and the 1250% tranche), on average for these transactions.
- c. A majority of transactions (38) include at least one mezzanine tranche. In 17 transactions, the whole mezzanine tranche has been sold. In 18 transactions, some part of the mezzanine tranche(s) has been retained (the retained amount ranges from 5 to 74% of the tranche). In 3 of these transactions, 100% of the mezzanine tranche has been retained (based on COREP data). This means that the quantitative test set out in 244(2)(a) CRR has not been met for these transactions and the comprehensive assessment has been carried out by the competent authority, under Art. 244(4) CRR.

451. As regards the senior tranche, in majority of transactions (38), the whole senior tranche has been retained by the originators (these are almost exclusively synthetic transactions). In 5 transactions, the whole senior tranche has been sold to investors (all these transactions are true sale). In the remaining 6 transactions, the part of the senior tranche retained ranges from 10 to 90% (these are almost exclusively synthetic transactions).

452. As regards the credit risk approach used by originators, in 15 cases the IRB Approach under the credit risk framework has been used, while in 5 cases the Standardised Approach has been applied. No further information on the credit risk approach has been made available for the remaining transactions.

### **Amount of 'protection' bought by the originator**

453. Following three paragraphs build on the data as regards the ratio of the detachment of the risk sold to KIRB, for the synthetic transactions, which represents the buffer of the protection an originator buys (taking into account the detachment point of the risk sold),



above the portfolio KIRB (i.e. EL + UL). The higher the amount is, the bigger the protection buffer is. For substantial majority of the synthetic transactions, the ratio ranges from 1 to 2.5 approximately.

454. The ratio is substantially higher for some transactions, all of which are traditional securitisations. However, not all the traditional transactions have a ratio of such a high level. This largely reflects the fact that most of the true sale transactions are primarily structured for funding purposes, which is maximised by selling the senior tranches. On the other hand, the main driver for concluding a synthetic transaction is to obtain the credit protection on the riskier tranches in the transaction (hence not covering the senior tranches or only covering a small fraction of the senior tranches), as well as to achieve the capital relief through SRT (considering that the CRR quantitative tests are focused on the transfer of risk associated with the first loss and mezzanine positions).
455. It should be taken into account that this analysis does not recognise the retained first loss tranche (as it only takes into account the level at which the sold risk detaches and disregards the level at which the sold risk attaches). This makes the analysis indicative for those transactions where the attachment point is higher than 0%. However, this is the case of a minority of the transactions (21), as for the majority of the transactions (28), the attachment point of the risk sold is indeed 0% (i.e. no part of the first loss tranche has been retained).

## Annex 4: Case studies of SRT transactions tested under the quantitative tests proposed by the EBA

456. The following case studies assess three examples of transactions under existing SRT tests as well as all the quantitative tests suggested by the EBA in the Section 3.3. More concretely, each transaction is assessed under:

- a. Existing SRT tests (1st loss test or mezzanine test, as applicable)
- b. New test on thickness of 1st loss tranche (as described under Option 1a in the Section 3.3)
- c. New test on commensurateness of the risk transfer (as described under Option 1b in the Section 3.3)
- d. New comprehensive test (as described under Option 2 in the Section 3.3)

457. Own funds requirements are calculated based on the new securitisation framework. Figure 28 summarises types of transactions selected for the case studies. The case studies, while realistic, do not represent actual transactions and are provided for illustrative purposes only.

Figure 28: Transactions assessed in the case studies

Case study	Approach to calculation of securitisation capital	STS/non-STS	Number of tranches	Excess spread
Case study 1	SEC-IRBA	STS	3 tranches	No
Case study 2	SEC-SA	STS	2 tranches	No
Case study 3	SEC-ERBA	Non-STS	5 tranches	Yes

## Case study 1:

### Situation:

Seniority	SRT sen. <sup>55</sup>	Rating	Balance notional (in ml)	A <sup>56</sup>	D <sup>57</sup>	T <sup>58</sup>	Retained (% of T)	RW (SEC-IRBA, STS)	Capital Charge (% notional) <sup>59</sup>
Senior	Senior	NR	920	8%	100%	92%	100%	12%	0.88%
Mezz	Mezz	NR	60	2%	8%	6%	0%	1061%	5.09%
First loss	First loss	NR	20	0%	2%	2%	100%	1250%	2%
Excess spread									No
Total securitisation capital									7.97%
Capital on retained tranches									2.88%
Underlying pool capital									5.33%
EL									0.78%
UL									4.55%
LGD									45%
WAL <sup>60</sup>									4.35 years

458. The securitisation transaction is a three-tranche structure. Originator applies own funds requirements under the SEC-IRBA. Underlying pool is assessed under IRB Foundation Approach. The securitisation qualifies for the STS capital treatment, and hence the lower own funds requirements under the STS framework apply. WAL of the underlying pool is 4.35 years. The originator retains 100% of the first loss tranche and 100% of the senior tranche. It sells 100% of the mezzanine positions. There is no excess spread feature in the transaction.

### Application of tests under Option 1:

#### Existing CRR test:

Passed

Given the transaction includes mezzanine tranche, mezzanine test is applied, according to which at least 50% of the RWEA of the mezzanine positions need to be transferred to third parties.

**As the originator transfers the whole mezzanine tranche, it passes the CRR mezzanine test.**

#### New requirement on the thickness of the first loss tranche:

Not passed

This requirement aims to ensure that the first loss tranche is sufficiently thick to cover losses that are expected to materialise through the maturity of the transaction (taking into account the weighted average maturity of the transaction).

<sup>55</sup> Seniority for the purpose of SRT, as per the definition of mezzanine tranche in the new securitisation framework

<sup>56</sup> Attachment point of the tranche

<sup>57</sup> Detachment point of the tranche

<sup>58</sup> Thickness of the tranche

<sup>59</sup> = thickness of the relevant tranche X risk weights X 8%

<sup>60</sup> Weighted average life of the underlying portfolio

As this transaction includes a mezzanine tranche, it is required that the first loss tranche at least cover lifetime EL, to avoid that the mezzanine tranches do not cover a sufficient amount of the UL.

As SEC-IRBA is used, lifetime EL is calculated as follows:

$$\text{Lifetime EL} = 1 \text{ year EL} \times \text{WAL of the securitised exposures} = 0.78\% \times 4.35 \text{ years} = 3.39\%$$

As the thickness of the first loss tranche is 2%, the test has proved that it is insufficiently robust to cover appropriate amount of EL.

**The transaction therefore does not pass this test.**

**New test of commensurateness of risk transfer:**

**Passed**

This test is focused on assessment of the commensurateness of the transferred risk, by comparing the percentage capital reduction achieved by the originator (measured in Ratio 1) and the percentage amount of losses transferred to third parties (Ratio 2). It presumes that the risk transfer is commensurate as long as the amount of the transferred risk is higher than the amount of the capital reduction that the originator achieves in the transaction.

**Ratio1** (capital reduction as a %):

Own funds requirements pre-securitisation (Kirb):

$$\text{Kirb} = \text{UL} + \text{EL} = 4.55\% + 0.78\% = 5.33\%$$

Own funds requirements post-securitisation on the retained tranches:

$$= 0.88\% + 2\% = 2.88\%$$

$$\text{Ratio 1} = \frac{(\text{capital pre sec including EL}) - (\text{capital post sec. on retained pos.})}{(\text{capital pre sec including EL})} = \frac{5.33\% - 2.88\%}{5.33\%} = 45.96\%$$

**Ratio 2** (risk transferred to third parties as a %):

Lifetime EL + UL on the underlying portfolio:

$$= 3.39\% + 4.55\% = 7.94\%$$

Lifetime EL + UL on the transferred positions:

In order to compute this number, we consider the total amount of lifetime of EL and UL on the underlying portfolio, and deduct the portion that was retained. Subsequently, we allocate this amount to the tranches according to their degree of subordination. In this case, the total amount of lifetime EL and UL on the underlying portfolio is allocated to the first loss tranche (100% of which has been retained) and to the mezzanine tranche (100% of which has been sold).

$$= (\text{total lifetime EL and UL on the underlying portfolio}) - (\text{retained portion of lifetime EL and UL}) = 7.94\% - 2\% \text{ (i.e. 100\% of first loss tranche)} = 5.94\%$$

The transaction does not include excess spread feature.

$$\text{Ratio2} = \frac{(\text{Lifetime EL+reg.UL on transfered pos.})}{(\text{Lifetime EL+reg.UL of the underlying portfolio})} = \frac{5.94\%}{7.94\%} = 74\%$$

Since the percentage reduction in originator's capital (45.96% as computed in Ratio 1) is lower than the percentage of the risk transferred to third parties (74% as computed in Ratio 2), **the transaction passes the test and indicates that the transferred risk is commensurate.**

## Application of test under Option 2:

**New comprehensive test as an alternative to the above tests:**

**Passed**

According to this test, the transaction needs to comply with two conditions.

**Condition 1:**

This condition requires that the capital on retained positions (including 1-year excess spread where it exists), must not exceed the amount of 1-year EL and 50% of UL.

Amount of 1-year EL + 50% UL = 0.78% + (50% of 4.55%) = 3.05%.

As the capital on retained tranches in case of this transaction (2.88%) is lower than 3.05%, **the transaction complies with this condition.**

**Condition 2:**

This condition is only applicable to transactions assessed under SEC-ERBA, and is therefore not relevant in this case.

**As the transaction complies with the condition 1, it passes the test.**

## Case study 2:

### Situation:

Seniority	SRT sen. <sup>61</sup>	Rating	Balance notional (in ml)	A <sup>62</sup>	D <sup>63</sup>	T <sup>64</sup>	Retained (% of T)	RW (SEC-SA, STS)	Capital Charge (% notional) <sup>65</sup>
Senior	Senior	NR	960	4.00%	100.0%	96%	100%	26%	2.0%
First loss	First loss	NR	40	0.0%	4.0%	4%	20%	1250%	4.0%
Excess spread									No
Total securitisation capital									6.0%
Capital on retained tranches									2.8%
Underlying pool capital									4.0%
EL									0.2%
UL									3.8%
w <sup>66</sup>									0.4%
WAL <sup>67</sup>									4 years

459. The securitisation transaction is a two-tranche structure. Originator applies own funds requirements under the SEC-SA. Underlying pool is assessed under SA. The securitisation qualifies for the STS treatment, and hence the lower own funds requirements under the STS framework apply. WAL of the underlying pool is 4 years and historical rate of impaired loans (w) for similar portfolios of the originator is 0.4% per year. The originator retains 20% of the first loss tranche and 100% of the senior tranche. It sells 80% of the first loss tranche. There is no excess spread feature in the transaction.

### Application of tests under Option 1:

#### Existing CRR test:

Passed

Given the transaction does not include any mezzanine position, first loss test is applied, according to which maximum 20 % of the exposure value of the first loss tranche can be transferred and minimum 80% of such positions need to be transferred to third parties.

**As the originator transfers 80% of the first loss tranche, it passes the first loss test.**

#### New requirement on the thickness of the first loss tranche:

Passed

The test presumes that the first loss tranche at least covers the sum of lifetime EL (computed for the weighted average life of the transaction) and two thirds of the regulatory UL. This requirement aims to ensure that the first loss tranche is sufficiently robust to cover a major share of EL and UL, while as a minimum 80% of which need to be transferred to third parties.

<sup>61</sup> SRT seniority, for the purpose of SRT, as per the definition of mezzanine tranche in Articles 243/244(3) CRR

<sup>62</sup> Attachment point of the tranche

<sup>63</sup> Detachment point of the tranche

<sup>64</sup> Thickness of the tranche

<sup>65</sup> = thickness of the relevant tranche X risk weights X 8%

<sup>66</sup> Historical rate of impaired loans for similar portfolios of the originator per year

<sup>67</sup> Weighted average life of the underlying portfolio

As SEC-SA is used, lifetime EL is calculated as follows:

Lifetime EL = (Impaired loans x 0.5) x WAL of the securitised exposures = (0.4% x 0.5) x 4 years = 0.8%

The minimum required thickness of the 1<sup>st</sup> loss tranche = Lifetime EL + 2/3 UL = 0.8% + 2/3 x 3.8% = 3.33 %

The thickness of the first loss tranche is 4%, which leaves sufficient margin above the required thickness of 3.33%.

**The transaction passes the test.**

**New test of commensurateness of risk transfer:**

**Passed**

This test is focused on assessment of the commensurateness of the transferred risk, by comparing the percentage capital reduction achieved by the originator (measured in Ratio 1) and the percentage amount of losses transferred to third parties (Ratio 2). It presumes that the risk transfer is commensurate as long as the amount of the transferred risk is higher than the amount of the capital reduction that the originator achieves in the transaction.

**Ratio1** (capital reduction as a %):

Own funds requirements pre-securitisation (Ka):

$Ka = Ksa + w \times 0.5 = 3.8\% + 0.4\% \times 0.5 = 4.0\%$

Own funds requirements post-securitisation on the retained tranches:

= 20% of capital for first loss tranche + 100% of capital for senior tranche = (20% of 4%) + (100% of 2%) = 0.8% + 2% = 2.8%

$\text{Ratio 1} = \frac{(\text{capital pre sec including EL}) - (\text{capital post sec on retained pos.})}{(\text{capital pre sec including EL})} = \frac{4\% - 2.8\%}{4\%} = 30\%$

**Ratio 2** (risk transferred to third parties as a %):

Lifetime EL + UL on the underlying portfolio:

= 0.8% + 3.8% = 4.6%

Lifetime EL + UL on the transferred positions:

= (Lifetime EL + UL on the underlying portfolio) – (part of lifetime EL + UL on the retained positions) = 4.6% - (20% of 4%) = 4.6% - 0.8% = 3.8%

The transaction does not include excess spread feature.

$\text{Ratio 2} = \frac{(\text{Lifetime EL+reg.UL on transfered pos.})}{(\text{Lifetime EL+reg.UL of the underlying portfolio})} = \frac{3.8\%}{4.6\%} = 82.60\%$

Since the percentage reduction in originator's capital (30% as computed in Ratio 1) is substantially lower than the percentage of the risk transferred to third parties (almost 82.6% as computed in Ratio 2), **the transaction passes the test and indicates that the transferred risk is commensurate.**

## Application of test under Option 2:

**New comprehensive test as an alternative to the above tests:**

**Not passed**

According to this test, the transaction needs to comply with two conditions.

### **Condition 1:**

This condition requires that the capital on retained positions (including 1-year excess spread where it exists), must not exceed the amount of 1-year EL and 50% of UL.

Amount of 1-year EL + 50% UL = 0.2% + (50% of 3.8%) = 2.1%.

As the capital on retained tranches in case of this transaction (2.8%) is higher than 2.1%, **the transaction does not comply with this condition.**

### **Condition 2:**

This condition is only applicable to transactions assessed under SEC-ERBA, and is therefore not relevant in this case.

**As the transaction does not comply with the Condition 1, it does not pass the test.**

Note:

In order to meet the Condition 1, the originator would need to retain positions the own funds requirements for which would be lower than 2.1%. Therefore, positions for which the own funds requirements amount to at least 3.9% notional would have to be sold. Various combinations of sold/retained tranches are possible to meet condition 1:

- (1) Sell the senior and 50% of the Junior
- (2) Sell 65% of both the Senior and Junior
- (3) Sell 80% of the Junior and 40% of the senior
- (4) Sell 95% of the Junior and 5% of the senior



### Case study 3

#### Situation:

Seniority	SRT sen. <sup>68</sup>	Rating	Balance notional (in ml)	A <sup>69</sup>	D <sup>70</sup>	T <sup>71</sup>	Retained (% of T)	RW (SEC-ERBA non-STS) <sup>72</sup>	Capital Charge (% notional) <sup>73</sup>
Senior	Senior	AAA (CQS1)	1900	7%	100%	93%	0%	25%	1.86%
Mezz 3	Mezz	AA+ (CQS2)	46	4.7%	7%	2.3%	0%	98%	0.18%
Mezz 2	Mezz	AA (CQS2)	38	2.8%	4.7%	1.9%	0%	128%	0.19%
Mezz 1	Mezz	BBB- (CQS8)	38	1%	2.8%	1.8%	50%	422%	0.60%
Junior	Junior	BB (CQS10)	18	0.0%	1%	1%	50%	762%	0.60%
Total securitisation capital									3.43%
Capital on retained tranches									0.60%
Underlying pool capital									2.70%
EL									0.40%
UL									2.30%
w <sup>74</sup>									0.80%
WAL <sup>75</sup>									5 years

460. The securitisation transaction is a five-tranche structure. Originator applies own funds requirements under the SEC-ERBA. Underlying pool is assessed under SA. The securitisation does not qualify for the STS treatment, and hence non-STS own funds requirements apply. WAL of the underlying pool is 5 years and historical rate of impaired loans for similar portfolios of the originator is 0.8% every year. The originator sells 50% of BBB- and BB as well as 100% of the AA, AA+ and AAA tranche. It retains 50% of the BBB- and BB tranches. The transaction includes excess spread (0.12% per year).

#### Application of tests under Option 1:

##### Existing CRR test:

Passed

Given the transaction includes mezzanine tranches, mezzanine test is applied, according to which at least 50% of the RWEA of the mezzanine positions need to be transferred to third parties. Therefore, 50% of the

<sup>68</sup> SRT seniority, for the purpose of SRT, as per the definition of mezzanine tranche in Articles 243/244(3) CRR

<sup>69</sup> Attachment point of the tranche

<sup>70</sup> Detachment point of the tranche

<sup>71</sup> Thickness of the tranche

<sup>72</sup> For illustrative purposes and under the assumption that the credit assessments are not based or partly based on unfunded support provided by the institution itself (excess spread). Where a position is based or partly based on unfunded support, the institution shall consider that position as if it were unrated for the purposes of calculating risk-weighted exposure amounts for that position, in accordance with Art. 270c point d of new CRR).

<sup>73</sup> = thickness of the relevant tranche X risk weights X 8%

<sup>74</sup> Historical rate of impaired loans for similar portfolios of the originator per year

<sup>75</sup> Weighted average life of the underlying portfolio

RWEA of BBB-, AA and AA+ tranches which are identified as mezzanine positions for the purposes of SRT according to the new CRR, must be sold. This equals to a maximum of 0.64% of the total notional to be retained (= 50% of (0.18% + 0.19% + 0.6%).

As the originator only retains 50% of BBB- tranche which is 0.3%, **it passes the CRR mezzanine test.**

To note that according to the existing CRR, the junior position would be considered mezzanine position (given it is not 1250% risk weighted), and not the first loss position as according to the new CRR. This would mean that also the junior position enters the test, which would still be passed also in this scenario.

#### New requirement on the thickness of the first loss tranche:

Not passed

This requirement aims to ensure that the first loss tranche is sufficiently thick to cover losses that are expected to materialise through the maturity of the transaction (taking into account the weighted average maturity of the transaction).

As this transaction includes a mezzanine tranche, it is required that the first loss tranche at least cover lifetime EL, to avoid that the mezzanine tranches do not cover a sufficient amount of the UL. Excess spread (amount committed to the lifetime of the transaction) contributes to this minimum thickness requirement.

As SEC-ERBA is used, lifetime EL is calculated as follows:

$$\text{Lifetime EL} = (\text{Impaired loans} \times 0.5) \times \text{WAL of the securitised exposures} = (0.8\% \times 0.5) \times 5 = 2\%$$

$$\text{Lifetime excess spread} = 1 \text{ year excess spread} \times \text{WAL of the securitised exposures} = 0.12 \times 5 = 0.6\%$$

$$\text{Thickness of the first loss tranche for the purpose of this test} = 1\% + \text{lifetime excess spread} = 1\% + 0.6\% = 1.6\%$$

As the thickness of the first loss tranche is 1.6%, the test has proved that it is insufficiently robust to cover appropriate amount of EL expected to be materialised during the life of the transaction (2%). The first loss is insufficiently robust despite the fact that the excess spread that the originator commits to the lifetime of the transaction, contributes to the thickness.

**The transaction therefore does not pass this test.**

#### New test of commensurateness of risk transfer:

Not passed

This test is focused on assessment of the commensurateness of the transferred risk, by comparing the percentage capital reduction achieved by the originator (measured in Ratio 1) and the percentage amount of losses transferred to third parties (Ratio 2). It presumes that the risk transfer is commensurate as long as the amount of the transferred risk is higher than the amount of the capital reduction that the originator achieves in the transaction.

**Ratio1** (capital reduction as a %):

Own funds requirements pre-securitisation ( $K_a$ ):

$$K_a = K_{sa} + w \times 0.5 = 2.3\% + 0.8\% \times 0.5 = 2.7\%$$

Own funds requirements post-securitisation on the retained tranches:

$$= (50\% \text{ of capital charge of BB tranche}) + (50\% \text{ of capital charge of BBB- tranche}) = 0.3\% + 0.3\% = 0.6\%$$

$$\text{Ratio 1} = \frac{(\text{capital pre sec including EL}) - (\text{capital post sec on retained pos.})}{(\text{capital pre sec including EL})} = \frac{2.7\% - 0.6\%}{2.7\%} = 77.77\%$$

**Ratio 2** (risk transferred to third parties as a %):

Lifetime EL + UL on the underlying portfolio:  
 = 2% + 2.3% = 4.3%

Lifetime EL + UL on the transferred positions:  
 = Lifetime EL + UL on the underlying portfolio, from which we deduct the retained positions (i.e. 100% of 0.6%, 50% of 1% and 50% of 1.8% as the lifetime excess spread and the retained parts of BB and BBB-positions respectively) = 4.3% - 0.6% - 0.5% - 0.9% = 2.3%

For the purpose of this test, lifetime excess spread (based on WAL) is considered a retained securitisation position subject to 1250% RW. Lifetime excess spread is 0.6%.

$$\text{Ratio2} = \frac{(\text{Lifetime EL+reg.UL on transfered pos.})}{(\text{Lifetime EL+reg.UL of the underlying portfolio})} = \frac{2.3\%}{4.3\%} = 53.48\%$$

Since the percentage reduction in originator's capital (77.77% as computed in Ratio 1) is higher than the percentage of the risk transferred to third parties (53.48% as computed in Ratio 2), **the transaction does not pass the test and indicates that the transferred risk is not commensurate.**

### Application of test under Option 2:

**New comprehensive test as an alternative to the above tests:**

**Not passed**

According to this test, the transaction needs to comply with two conditions.

#### Condition 1:

This condition requires that the capital on retained positions (including 1-year excess spread), must not exceed the amount of 1-year EL and 50% of UL.

Capital on the retained tranches including 1 year excess spread = 0.6% + 0.12% = 0.72%

Amount of 1-year EL + 50% UL = 0.4% + (50% of 2.3%) = 1.55%

As the capital on retained tranches in case of this transaction (0.72%) is lower than 1.55%, **the transaction complies with this condition.**

#### Condition 2:

This condition requires that in case SEC-ERBA is used, 95% of the positions attaching below KA that are neither 1250% risk weighted nor deducted from CET1, must be transferred to third parties. In this transaction, this is the case of positions rated BB and BBB-. As the originator only transfers 50% of such positions, **it does not comply with this condition.**

**As the transaction does not comply with both conditions, it does not meet the test.**