

EBA draft Regulatory Technical Standards

[TO BE MERGED INTO ONE LEGAL TEXT WITH EBA-RTS-2013-01 AND EBA-RTS-2013-02 AS PER INDICATIONS THEREIN]

on the concept of Gain on Sale associated with future margin income in a securitisation context under Article 32(2) of Regulation (EU) 575/2013 (Capital Requirements Regulation – CRR)

EBA draft Regulatory Technical Standards on the concept of Gain on Sale associated with future margin income in a securitisation context under Article 32(2) of Regulation (EU) 575/2013 (Capital Requirements Regulation – CRR)

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1. Executive summary

The RTS on gain on sale will be merged with the draft Regulatory Technical Standards (RTS) on own funds (Part I) and should be read together with these.

Regulation (EU) 575/2013 ('CRR') establishes as a general principle that institutions shall exclude from their own funds increases in equity resulting from the sale of assets being transferred in a securitisation transaction. As required by Article 32(2) of the CRR, these draft RTS further specify the concept of gain on sale in order to harmonise interpretation of Article 32(1)(a) of the CRR by institutions.

When transposing the accounting framework into the prudential framework and the solvency requirements, the following scenarios are possible. Either there is i) no de-recognition of the financial assets or there is ii) de-recognition or continuing involvement. Under i) the issue of 'gain on sale' does not arise and under ii) a gain sale could be booked, i.e. acknowledged, when the assets are derecognised from the balance sheet.

As a result of the above, the gain on sale resulting from future margin income in the context of a securitisation transaction in the prudential framework can be derived following the determination of the gain on sale according to the relevant accounting framework.

2. Background and rationale

Both Basel III¹ and the new Capital Requirements Regulation (CRR), which seeks to implement the former in the EU, establish as a general principle that institutions shall exclude from their own funds increases in equity resulting from the sale of assets being transferred in a securitisation transaction. This principle is, however, not new, as it already existed in the previous regulatory framework (Basel II and Directive 2006/48, respectively for the international and the European context).

In particular, Basel III (paragraph 74) relates to the gain on sale on securitisation transactions and states:

'Derecognise in the calculation of Common Equity Tier 1 any increase in equity capital resulting from a securitisation transaction, such as that associated with expected future margin income (FMI) resulting in a gain-on-sale.'

The CRR, Article 32(2) (in the prudential filters section), states:

'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.'

Directive 2006/48 does not mention in Article 57 the term 'gain on sale', but states:

'In the case of a credit institution which is the originator of a securitisation, net gains arising from the capitalisation of future income from the securitised assets and providing credit enhancement to positions in the securitisation shall be excluded from the item specified in point (b)'

Moreover, Directive 2006/48 requires, in Annex XII, the disclosure of the bank's accounting policies on the recognition of gains on sales (Pillar III of the Basel framework).

Therefore, the exclusion (from the corresponding element of own funds) of increases associated with future margin income is not a new requirement in the European regulatory framework.

As required by Article 32(2) of the CRR, these draft RTS further specify the concept in order to harmonise interpretation of Article 32(1)(a) of the CRR by institutions.

¹ International Convergence of Capital Measurement and Capital Standards, Basel Committee on Banking Supervision, June 2004 and further revisions.

Concept of gain on sale in accounting and in the prudential framework

In the language used by the International Accounting Standards Board (IASB), the 'gain or loss from derecognition' is related to transfers of financial assets². The International Financial Reporting Standards (IFRS) provide rules for derecognition of an asset (or assets) and for when a gain or loss on sale is considered to have occurred.

When transposing the accounting framework into the prudential framework and the solvency requirements, the following scenarios are possible:

a) No derecognition of the financial assets

When, according to IFRS, there is no derecognition of the financial assets, the issue of 'gain on sale' does not arise. In these circumstances, it is expected that the originator will not recognise a gain on sale. Instead, the entity will continue to recognise income and expenses for the assets and the newly recognised liabilities. For instance, an entity could sell loans and compensate the transferee for any loss on the loans by providing a corresponding guarantee.

b) Derecognition or continuing involvement

If there is derecognition or continuing involvement³, then a gain on sale could be booked, i.e. acknowledged, when the assets are derecognised from the balance sheet.

As a result of the above, the gain on sale resulting from future margin income in the context of a securitisation transaction in the prudential framework can be derived following the determination of the gain on sale according to the relevant accounting framework.

Future margin income and excess spread

In this context, 'future margin income' shall refer to the expected future 'excess spread' as defined in Article 242(1) in the CRR.

If the gain on sale arising from the 'future margin income' has been excluded from own funds, the corresponding asset should be excluded from the application of capital requirements.

² Derecognition is the removal of a previously recognised financial asset or financial liability from an entity's balance sheet (IAS 39, paragraph 9).

³ Continuing involvement is the extent to which the entity is exposed to changes in the value of the transferred assets (IAS 39, paragraph 30).

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3. EBA draft Regulatory Technical Standards on the concept of Gain on Sale associated with future margin income in a securitisation context under Article 32(2) of Regulation (EU) 575/2013



EUROPEAN COMMISSION

Brussels, **XXX**
[...](2012) **XXX** draft

COMMISSION DELEGATED REGULATION (EU) No .../..

of **XXX**

[...]

COMMISSION DELEGATED REGULATION (EU) No .../..

Supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for the concept of gain on sale in Article 32(2)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012⁴, and in particular Articles [...] and 32(2) third subparagraph thereof, *[TO BE ADDED TO THE LEGAL BASES OF THE OWN FUNDS PART 1 TEXTS- EBA-RTS-2013-01]*

Whereas:

...[THIS RECITAL TO BE ADDED TO THE RECITALS OF THE OWN FUNDS PART 1 LEGAL TEXT EBA-RTS-2013-01 AFTER RECITAL 10]

(11) There is a need to define and align the treatment of the concept of gain on sale associated with a future margin income in the context of securitisation, with international practices (i.e. those defined by the Basel Committee on Banking Supervision) and ensure that no revocable gain on sale is included among the own funds of an institution, given the lack of its permanence.

....

TITLE I

Subject matter and definitions

Article 1

Subject matter

This Regulation lays down uniform rules concerning:

.... [TO BE ADDED TO ART. 1 OF OWN FUNDS PART 1 LEGAL TEXT EBA-RTS-2013-01, AFTER POINT d)]

e) the further specification of the concept of gain on sale according to Article 32(2) of Regulation (EU) No 575/2013;

....

⁴ OJ L 176, 27.6.2013, p. 1.

.....

[TO BE ADDED TO THE ARTICLES OF THE OWN FUNDS PART 1 LEGAL TEXT- EBA-RTS-2013-01]

Section 2

Prudential Filters

Article 9 - The concept of gain on sale under Article 32(1)(a) of Regulation (EU) No 575/2013

1. The concept of gain on sale referred to in point (a) paragraph 1 of Article 32 of Regulation (EU) No 575/2013 shall mean any recognised gain on sale for the institution that is recorded as an increase in any element of own funds and is associated with future margin income arising from a sale of securitised assets when they are removed from the institution's balance sheet in the context of a securitisation transaction.
2. The recognised gain on sale shall be determined as the difference between (a) and (b) below as defined in the application of the relevant accounting framework:
 - (a) the net value of the assets received including any new asset obtained less any other asset given or any new liability assumed
 - (b) and the carrying amount of the securitised assets or of the part derecognised.
3. The recognised gain on sale which is associated with the future margin income, shall refer, in this context, to the expected future 'excess spread' as defined in Article 242 of Regulation (EU) No 575/2013.

4. Accompanying documents

4.1 Cost–benefit analysis/impact assessment

Introduction

According to the Capital Requirements Regulation (CRR), the EBA shall develop draft regulatory technical standards (RTS) with regard to the concept of gain on sale associated with future margin income in a securitisation context under Article 32(2) of the CRR.

Problem definition

Accounting rules allow institutions to recognise gains from the sale of assets being transferred to a securitisation position. These gains may be only potential and the size of the gain that will actually be earned in the future may differ significantly. Because of this, it would not be suitable for institutions to treat these gains as a regular component of earnings for prudential purposes, as it would automatically increase the level of their regulatory capital without, in some cases, increasing their actual ability to absorb future losses.

Basel II⁵ and Basel III and Directive 2006/48 establish as a general principle that institutions shall exclude from their own funds increases in equity resulting from the sale of the assets being transferred in a securitisation transaction. Therefore, the exclusion (from the corresponding element of own funds) of increases associated with future margin income for an institution is not a new requirement in the CRR.

Objectives of the technical standards

The objective of this technical standard is to achieve a common understanding of the concept of gain on sale through future margin income across Europe and to reduce the likelihood of misinterpretation by institutions of Article 32(1)(a) of the CRR, as required by Article 32(2).

Option considered and impact

Instead of requiring the drafting of a technical standard to clarify the concept of gain on sale for future margin income for securitised assets, Article 32 in the CRR could have been redrafted in order to clarify the concept.

The exclusion (from the corresponding element of own funds) of increases associated with future margin income that result in a gain on sale for an institution is not a new requirement in the CRR. Directive 2006/48 already establishes as a general principle that institutions shall exclude from their

⁵ International Convergence of Capital Measurement and Capital Standards. Basel Committee on Banking Supervision, June 2004 and further revisions.

own funds increases in equity resulting from the sale of the assets being transferred in a securitisation transaction.

For this reason, the impact and costs and benefits related to this draft RTS are unlikely to be of any significance.

4.2 Feedback on the public consultation and on the opinion of the BSG

The EBA publicly consulted on the draft proposal contained in this paper.

The consultation period lasted for two months and ended on 12 August 2012. Three responses were received, all of which were published on the EBA website.

This paper presents a summary of the key points and other comments arising from the consultation, the analysis and discussion triggered by these comments, and the actions taken to address them where deemed necessary.

In many cases, several industry bodies made similar comments or the same body repeated its comments in response to different questions. In such cases, the comments and the EBA's analysis are included in the section of this paper that the EBA considers most appropriate.

Changes to the draft RTS have been incorporated as a result of the responses received during the public consultation.

Summary of key issues and the EBA's response

In general, the comments on and responses to the questions raised in the consultation paper were positive and supportive of the EBA's work and sought only some minor clarification.

Market participants did not object to the definition of 'future margin income' as expected future 'excess spread' in Article 242 of the CRR; however, they suggested further clarification of the terms 'future margin income' and 'gain on sale', and asked that examples be included.

The EBA has introduced changes to the draft RTS to address these comments.

NB: Please note that references to articles of the CRR in the feedback statement follow the original numbering of the CRR, i.e. that of the European Commission legislative proposals for the CRR, which the EBA also used when it launched its consultation at the time (when a final CRR text had not yet been adopted).

Summary of responses to the consultation and the EBA's analysis

Comments	Summary of responses received	EBA analysis	Amendments to the proposal
General comments			
	<p>The EBA website page on which the consultation was published said, 'The concept of gain on sale is mainly relevant for financial institutions using the US GAAP as [sic] accounting standard.' However, under current GAAP (post-FAS 166 and 167), as under IFRS, we understand that it is, generally speaking, difficult to achieve derecognition where the originator retains an interest in the securitisation, whether through a retained tranche of credit enhancement, entitlement to ongoing excess spread or both. Both of these features are important at present for European securitisation business models and structures. Further, since the implementation of Article 122a of the Capital Requirements Directive in January 2011, in many cases credit institutions have faced another obstacle to achieving derecognition because, if any credit institutions (or, eventually, other types of EU-regulated investors) invest in or acquire credit exposure to the transaction, the originators/sponsors/original lenders are required to retain a tranche of risk.</p>	<p>The EBA acknowledges the comment.</p>	<p>No change to proposal</p>
	<p>Given that future margin income is future excess spread, which is not of a fixed size – rather it depends on the performance of the collaterals and interest rates such as</p>	<p>The EBA acknowledges the comment.</p>	<p>No change to proposal</p>

	Euribor – we are in line with the RTS that the expected gain on sale in connection with this income from a securitisation must not be accounted as own equity.		
	It would be beneficial if specific examples were included in the guidelines/explanatory notes accompanying the RTS, to illustrate the application of the concept of gain on sale associated with future margin income.	The EBA is currently considering ways of accommodating the inclusion of numerical examples in the accompanying documents to the RTS.	No change to proposal
Responses to questions in Consultation Paper EBA/CP/2012/07			
Question 1	<p>As a practical observation, the definition of ‘excess spread’ in Article 237 [442] of the CRR seems to be unobjectionable. Perhaps it might be clearer in the RTS simply to refer to ‘excess spread’ (as so defined), and achieve consistency of definition, rather than use a separate term such as ‘future margin income’. The latter is rather unclear, as it raises the question of whether it is income gross or net of costs. We believe the intention is for it to mean net of costs. This ambiguity could be reduced by using the term ‘excess spread’ or ‘future excess spread’ instead.</p> <p>We believe that the term ‘future margin income’ is currently not sufficiently clearly defined in the paper as drafted.</p> <p>The consultation paper only states that future margin income is the expectation of receiving the total or part of the ‘future excess spread’ as defined in Article 237 [442] CRR.</p> <p>However, we believe that the term ‘future margin income’ is currently not sufficiently clearly defined in the</p>	<p>It is not possible to refer directly to ‘excess spread’ in the RTS without referring to ‘future margin income’ because of the constraints created by the language used in Article 29(1)(a) [32(1)(a) of the CRR.</p> <p>Only the expected future (i.e. unrealised) part of the excess spread as defined in Article 237 [442] CRR shall be considered equivalent to the future margin income in this context.</p> <p>The EBA has changed the wording in the draft RTS in order to reduce the risk of misinterpretation.</p>	<p>Clarified the concept of ‘gain on sale associated with future margin income’ and the steps to follow to filter it from own funds</p>

	paper as drafted.		
Question 2	We would suggest that it be clarified in the RTS that Article 9 applies only to situations where the gain on sale is revocable (i.e. where the credit institution as originator is still exposed to securitisation risk in so far as it is still exposed to the risk of losses to the underlying assets).	In principle, a gain on sale can be included in the own funds of the institution if derecognition of the securitisation transaction has been achieved under the accounting framework and the institution is no longer exposed to any risk from the securitisation transaction.	No change to proposal
Responses to other comments			
	For example, assume a simple group of loans with a carrying amount of 100 which has been securitised and for which derecognition is achieved. Assume that loans with a carrying amount of 100 were sold for a total consideration of 103. As the document points out, under IFRS a profit of 3 would be recognised (as prescribed in steps 1 and 2 on page 12 of the consultation). If you assume further that the consideration received consisted of cash of 100 and a new financial instrument, say an interest-only strip (assume that the interest-only strip did not itself prevent derecognition of the loans) for which the fair value was determined to be 3 at the date of the securitisation, then would the 'finance charge collections' be related to the future revenue arising from the interest-only strip, or does the finance charge comprise the portion of the gain on sale attributable to the 'ongoing involvement' in the loans? Further, once the ongoing involvement ceases and all cash flows are received, would it, only at that point, be appropriate to add back	The aim of Article 29 [32] of the CRR is to exclude from the own funds of an entity any component of the own funds that results from securitised assets. Additionally, as mentioned in the recital (e) to the RTS, 'there is a need [...] to ensure that no revocable gain on sale is included among the own funds of an institution'. The aim of the RTS required by Article 29.2 [32.2] of the CRR is to particularly specify the concept of the 'gain on sale' resulting from the 'future margin income' (FMI) in a securitisation transaction. The RTS clarifies that FMI in this context shall be equivalent to the expected future 'excess spread' as defined in Article 237 [442] of the CRR. In this particular example, it seems that under IFRS the 3 units of 'gain on sale' in the form of an interest-only strip would be recorded as part of the entity's equity. Nevertheless, as this gain appears to be revocable because it would depend on the highly uncertain FMI/future excess spreads, the regulatory filter should	No change to proposal

	the future margin income so defined at that point?	be applied and, accordingly, the gain must be excluded from own funds for solvency purposes. After a certain amount of the gain on sale has become irrevocable, the filter would no longer apply to this part of the gain on sale.	
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