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Securitisation: Risk transferred or not?

An evolving European landscape

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Executive summary

At a time when regulatory capital burdens are increasing, there is a clear shift towards greater scrutiny of capital relief transactions. Regulated firms should therefore be increasingly mindful of how they broaden their capabilities to manage capital resources, even if they appear not to be particularly constrained by prudential regulatory requirements currently.

Even in the midst of this heightened scrutiny, Significant Risk Transfer (SRT) transactions still have the potential to help firms manage their Risk Weighted Exposure Assets (RWEAs) in a sensible manner. However, firms wishing to engage in such transactions need to be mindful of the regulatory expectations beyond the mechanic tests of the Capital Requirements Regulation[1] (CRR).

In the aftermath of the financial crisis, European regulated credit institutions have had mixed fortunes in the field of securitisation transactions executed for the purpose of achieving regulatory capital relief. These fortunes have been driven by how each member state's National Competent Authority (NCA) has sought to exercise its discretion under the SRT regime of the CRR to appraise whether the capital relief achieved was commensurate with the level of risk transferred.

In an effort to improve consistency, the European Banking Authority (EBA) published guidelines[2] in 2014 on how they expect to see a greater harmonisation of the supervisory practices overseeing SRT transactions employed across European Union (EU) member states. With the more recent advent of the European Central Bank's Single Supervisory Mechanism (ECB-SSM) and Joint Supervisory Teams (JSTs), there is an evident opportunity for alignment of regulatory capital relief practices amongst SSM banks. In this paper we explore some of the drivers and consequences of what we expect to be a more stringent regulatory oversight for the SRT regime.

Key considerations

- **Robust European securitisation markets:** European central banks and regulators are focused on ensuring the re-emergence of a European securitisation market is not impacted by financial engineering practices that could undermine the confidence of market participants;
- **Less mechanistic:** There is likely to be a significantly reduced ability of originator institutions to use only the mechanistic tests in CRR articles 243(2) and 244(2);
- **More stringent SRT application:** European regulatory requirements for the demonstration of Significant Risk Transfer appear to be converging on a more stringent standard than that applied currently in most member states, whereby the demonstration of commensurate risk transfer will now be necessary;
- **Embedded governance:** Better demonstration of appropriate governance over the understanding of risk and risk management existing in both exposures to be securitised and retained tranches of securitisation exposures.

SRT has the potential to help firms manage their RWEA in a sensible manner.

1. European Parliament and Council, Capital Requirements Regulation, June 2013
2. European Banking Authority Guidelines on Significant Risk Transfer for Securitisation, July 2014

Why Significant Risk Transfer?

During the past two decades, securitisation markets have served as a key means for transferring the credit risk associated with particular segments of a regulated firm's balance sheet to other parties with an appetite for credit risk. With the transfer of credit risk, financial services institutions have sought to redeploy, or leverage, the capital released. However not all securitisation originators have securitised assets from their balance sheets for the purposes of achieving capital relief. Many originators participated in the securitisation market with a primary intent to simply diversify their sources of funds.

The transfer of risk to third parties is accepted by regulators as a legitimate means of risk mitigation and consequentially of reducing capital requirements. Recent decades have seen capital markets design solutions to the age-old consideration of securely transferring risk between counterparts. The innovations of the structured funding markets through securitisation transactions, and the derivatives markets through the development of Credit Default Swaps (CDS), have created a path by which financial engineering can efficiently transfer the risk of loans and other exposures away from the balance sheet of financial services institutions, to other entities not at the core of the regulated financial services sector.

The optimal use of capital, be that required by regulators or that determined by firms as being necessary to absorb their own expectations on losses, is at the core of an efficient commercial operation. Under ever increasing competitive pressures, regulated financial services institutions have sought ways in which to ensure the capital at their disposal is being deployed in the most efficient and profitable manner, within the context of each individual firm's business model.

There have also been competing pressures; firstly from tensions amongst firms competing for market share, and secondly between regulatory demands for increasing levels of capital which is counter-balanced by the desire of regulated firms to hold the optimal amount of capital.

For those firms using securitisation for the transfer of credit risk, regulatory consideration of SRT is one of the methods available to achieve a reduction in capital requirements. Per the regulatory requirements outlined in the CRR, SRT may be achieved through the execution of either a synthetic securitisation or a cash securitisation transaction. However regulatory considerations around related issues of risk transfer, certainty of loss protection and counterparty credit risk are diluting the fundamental difference between synthetic and cash securitisation, i.e. in the nature of up-front "funding" of protection.

There are many factors that might influence firms' appetite to execute SRT transactions, these could include:

- Constraints to the availability of capital;
- The most efficient use of available capital;
- Desire to maintain market presence in asset classes that lead to a sub-optimal deployment of capital;
- Appetite to enter new market segments or product lines.

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SRT under Capital Requirements Regulation

CRR articles 243 and 244 outline the key considerations for regulated firms undertaking SRT transactions. The articles permit firms to make their own determinations as to whether SRT requirements are satisfied. These articles also permit NCAs to consider if the approach taken by
a firm, in appraising how SRT requirements are satisfied, appropriately considers how the level of capital relief achieved is commensurate with the risk transferred to third parties.

Significant vs commensurate

Within the mechanistic tests the use of phrases such as "reasoned estimate" and "substantial margin", encourages regulated firms to apply judgement in determining the appropriateness of the protection provided and consequentially the level of risk transferred. In the context of this judgement, the concluding lines of each of 243(2) and 244(2) also introduce the concept of commensurate risk transfer, whereby regulatory bodies are permitted to assess whether the level of regulatory capital relief taken by firms is commensurate with the level of risk transferred. The use of the phrase "commensurate risk transfer" within the context of articles considering the recognition of SRT has caused much debate on which of the two concepts should take precedence.

Much of the discussion has centred on:

- How much risk should be considered significant? For example, should this involve the transfer of exposures in excess of £100million, £500 million, £1 billion or greater? Or should it be more than 50%, 75% or 95% of an exposure?

- How should the level of regulatory capital relief be determined? If the level of risk transferred met with the interpretation of significant, then how much capital needs to be held against any residual risk remaining with the regulated firm executing the securitisation transaction?

- How should commensurate interplay with significant? What relationship should there be between the level of risk transferred (significant or otherwise) and the level of regulatory capital relief? Should these numbers be directly proportional?

- How should the level of risk transferred be measured, if not through the level of RWEAs?

The mechanics of the Mechanistic Tests

Subparagraph (2) of each of articles 243 and 244 outline what have come to be referred to by market participants as the "Mechanistic Tests", which if satisfied, are seemingly sufficient for firms to take the resulting capital relief. The tests essentially permit firms to take regulatory capital relief if they transfer the risk to an independent third party in relation to:

- At least 50% of the risk weighted exposure amounts (RWEA) of all mezzanine tranches in the securitisation, where mezzanine tranches are all tranches that are (a) not the most senior tranche and (b) subject to a risk weight of less than 1250% and are more junior to either

  (i) a Credit Quality Step (CQS) 1 rated tranche within the Standardised risk weight framework or (ii) a tranche rated either CQS 1 or CQS 2 under the Internal Ratings Based approach.

  $$\sum_{i=1}^{N} RWEA_{i,Retained} \leq 50\% \sum_{i=1}^{N} RWEA_{i}$$

  for all (N) mezzanine tranches in the transaction

- At least 80% of the exposure value of securitisation positions that are either 1250% risk weighted or would be subject to a deduction from Common Equity Tier 1, subject to

  (a) there being no mezzanine positions in the transaction structure and
  (b) the exposure value of positions that would be either 1250% risk weighted or deducted from CET 1 substantially exceeds a reasonable estimate of the expected loss on the underlying assets.

  $$\sum_{i=1}^{N} RWEA_{i,Retained} \leq 20\% \sum_{i=1}^{N} RWEA_{i}$$

  for all (N) tranches in the transaction that would be either 1250% risk weighted or subject to a deduction from CET 1.

The use of the phrase "commensurate risk transfer" within the context of articles considering the recognition of SRT has caused much debate.

Articles 243(5) and 244(5) highlight some further aspects that originators ought to consider. Key amongst these is that the economic substance of the transaction is reflected in the transaction documentation. Most market participants would take this statement as a matter of fact, however the requirement guides regulated entities to consider the economic substance of the transaction and how this is considered not only as part of the transaction documentation, but also as part of the internal approvals and governance processes of the regulated entity, when determining the level of economic risk transfer achieved.

The practical consideration of these questions has been at the heart of the evolution of regulatory interpretations and implementations across the various jurisdictions covered by the CRR. For regulated firms, the key aspects that are coming through from the CRR are that they should be prepared to justify the commensurate nature of risk transfer, and that this justification should be based on measures of risk that are not constrained to regulatory RWEAs.

Credit granting and originate-to-distribute

In light of the association of the originate-to-distribute (OTD) model as one of the root causes of the financial crisis in 2008, there is particular regulatory scrutiny to the re-emergence of the OTD business model. In the context of the execution of transactions for SRT purposes, submitting firms ought to be mindful that regulators will review proposed transactions and business rationales through the application of CRR articles 405 and 408. The focus of article 405 is well understood by market participants as being the satisfaction of risk retention requirements while article 408 focuses on criteria for credit granting. Article 408 clarifies regulatory expectations that the process of credit granting applied to exposures to be securitised must be the same as the process applied by the regulated entity to exposures held on its own non-trading book. In essence these requirements are targeted at curtailing the originate-to-distribute activities. In large part this should not affect most regulated entities who are in the on-going business of credit origination and credit risk retention, but may be of particular consideration for regulated non-bank financial institutions and non-regulated entities seeking to satisfy other regulatory requirements for securitisations, such as risk retention.

Implementation of the CRR by the Prudential Regulatory Authority

Option	Mechanism	CRR Ref	PRA Requirement
1	The originator retains no more than 50% of RWEA of mezzanine tranches	Art. 243(2) (a) & Art. 244(2)(a)	PRA notifications process including commensurate risk transfer analysis
2	Where there is no mezzanine position, the originator holds no more than 20% of the exposures of securitisation positions subject to a deduction or 1250% risk weight	Art. 243(2) (b) & Art. 244(2)(b)	PRA notifications process including commensurate risk transfer analysis
3	Competent authority may allow an originator to make its own assessment if it is satisfied that the originator can meet certain requirements	Art. 243(4) & Art. 244(4)	PRA Waivers process, applicable for 1 year and for aggregate capital relief of less than or equal to 5% of credit risk RWEA
4	The originator applies a 1250% risk weight to all retained positions		Not required to notify the PRA
5	The originator deducts all retained positions from capital resources		Not required to notify the PRA

SRT and the European Banking Authority

With responsibility to contribute to the creation of a European Single Rulebook, the EBA is focused on providing a single set of harmonised prudential rules for EU financial institutions. The consultation paper notes that the proposed guidelines apply to both NCAs and originator institutions subject to article 243 and 244 of the CRR. Through this scope of application the EBA aims to not only encourage originator institutions to consider how the requirements of CRR articles 243 and 244 apply to their transactions, but also to encourage a consistent review by NCAs of transactions proposed by regulated originator institutions.

The EBA Guidelines on SRT acknowledge the existence of potential capital arbitrage within the credit risk mitigation framework via the use of securitisation transactions. Two key factors contributing to such an arbitrage are recognised as being (i) when the costs of protection are recognised and (ii) capital relief being claimed even when there is no meaningful transfer of risk. The guidelines go on to acknowledge that "in practice, originator institutions can technically satisfy the rules for the recognition of SRT, without actually achieving commensurate risk transfer".

As a consequence, the EBA guidelines highlight the importance for NCAs and originator institutions to consider a broad range of factors in determining if risk, commensurate to the level of capital relief being taken, has been transferred to a third party. By outlining directed guidance both to NCAs and to originator institutions, the EBA is providing transparency on the nature of factors originator institutions may wish to consider providing to NCAs, in order to facilitate a more efficient and consistent consideration of SRT transactions across the EU.

Overall the EBA Guidelines clarify that it should no longer be sufficient for originator institutions to execute transactions for capital relief simply by applying the mechanistic tests, but that such transactions will be subject to the scrutiny of NCAs to demonstrate how the risk transferred is not only significant but also commensurate to the level of capital relief being sought. The requirements outlined in the final guidelines on SRT, published by the EBA on 14 July 2014, were required to be complied with by NCAs no later than six months after publication.

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Some key factors considered by NCAs include:

- **Performance:** History of securitised exposures and how this could affect retained tranches and compare with the cost of risk transfer incurred;
- **Analytical approaches:** Integrity and appropriateness of expected loss level determination and how this is informed by institutional knowledge of the assets;
- **Structural features:** Aspects of transactions that allow for the on-going transfer to third parties of risk on assets for the full remainder of their tenor to be undermined and revert to the originator institution.

In order to inform the consideration of the above factors by NCAs, the EBA Guidelines on SRT identify that originator institutions should focus on clearly articulating:

- **Governance:** Review and approval of capital relief transactions by an established and considered governance process as part of an overall institutional strategy for risk management and internal capital allocation;
- **Self-assessment of risk transfer:** This alludes to the approaches employed and how these have considered the economic credit risk retained and transferred, specifically indicating the use of the originator institution's own economic capital in comparison to the institutions' own funds requirements. The guidelines also allude to the practice of appraising and valuing the economic substance of the transaction, through carrying out present value analysis of premia and costs of risk transfer alongside the emergence of losses (expected and unexpected) arising not only from the underlying assets but also from any timing and risk-mitigating counterparty credit considerations.

SRT and the Prudential Regulatory Authority

Insights gained from discussions with regulators and regulated firms have identified that the UK implementation of the SRT regime is amongst the most demanding of European regulatory authorities, with respect to the information required to be submitted for regulatory scrutiny. This enhanced scrutiny has been in place since the publication in 2011 of the Financial Services Authority's (FSA) SRT waivers and notifications regime[3] (adopted by the PRA in 2013[4]), and considered by many industry commentators as being too restrictive to the execution of SRT transactions in the UK and thereby not contributing to the achievement of a level playing field for UK firms in comparison to their European counterparts. In this vein the efforts of the EBA to harmonise the analysis to be undertaken by NCAs on SRT transactions, ought to be considered as a step in the right direction for creating a level playing field.

The details of the specific information to be submitted are contained in the PRA supervisory statement on SRT waivers and notifications. These details are not too dissimilar to the information outlined in the EBA final guidelines.

The background to the PRAs adoption in 2013 of the FSAs legacy policy on the SRT waivers and notifications regime and the focus on demonstration of commensurate risk transfer, shows a clear commitment by UK regulators to prevent the re-emergence of practices observed in the period of 2007 through 2010; where regulated firms executed transactions motivated by reducing capital requirements in the current year, at the cost of guaranteed reduction of capital resources in future years. This desire, as well as the information outlined in the CRR, is a critical indicator for regulated firms as to how they could interpret the PRA information request and how they might communicate strategic intentions as captured not only in the execution and structuring of transactions, but also how this is reflected in the breadth and depth of internal governance applied to transactions before they are presented to regulators.

With the publication of the EBA guidelines on SRT transactions, firms across the EU may wish to take note of the experience of UK regulated firms as they approach the unchartered territory of commensurate risk transfer.

The UK implementation of the SRT regime is amongst the most demanding of European regulatory authorities.

SRT and the European Central Bank

With the commencement of the ECB-SSM in November 2014, supervision of the significant Eurozone banks shifted from the NCAs of the member states to the ECB-SSM. In March 2016 the ECB-SSM issued its first piece of public guidance on the recognition of significant credit risk transfer[5].

In it they set out how they expect significant banks to engage with them when applying for capital relief on their securitisation transactions. While the information requests detailed in Annex I of the guidance are similar to the PRAs requirements, there are a couple of notable differences to the PRAs approach:

- **Timing:** the ECB-SSM guidance states they wish to be notified three months in advance of the expected closing date of the transaction, versus the PRAs requirement of one month post-closing
- **Confirmation:** the ECB-SSM guidance states that SRT will not be recognised until the ECB-SSM adopts an individual decision, versus the PRA who allow banks to take capital relief ahead of receiving a non-objection notice from the PRA

Therefore significant banks looking for capital relief should consider how well developed their transaction is before they approach the ECB-SSM.

3. FSA Significant risk transfer (SRT) waivers and notifications, January 2011

4. PRA Supervisory Statement LSS11/13, Securitisations: significant risk transfer waivers and notifications, April 2013

5. ECB-SSM guidance on the recognition of significant credit risk transfer, March 2016

The mechanics of SRT

The phrase "mechanics of SRT" conjures up the image of a page full of complex formulae and structure diagrams, focused on the objective of optimising the level of capital that it might be possible for a regulated firm to hold and how this might involve the distribution of risk to independent third parties.

While this is one crucial part of achieving capital relief, the qualitative considerations of governance, institutional knowledge of assets and structure, along with the operational and systems capabilities to monitor and demonstrate SRT on an on-going basis for the remaining life of the transaction, are also key considerations. Without demonstration of these considerations, a regulatory non-objection may prove to be as elusive on an on-going basis, as if a poorly structured transaction had been presented.

As a result, the mechanics of regulatory SRT determination are fundamentally focused not on calculations of RWEAs, which regulators are generally comfortable with, but rather factors such as:

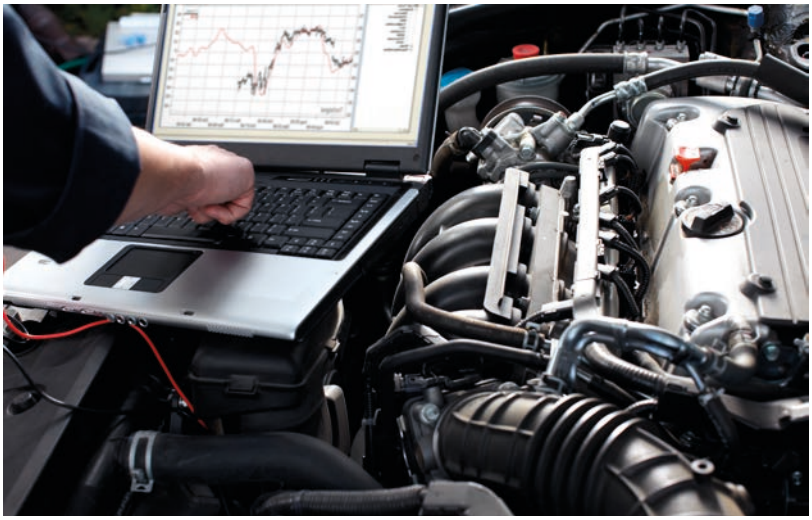
- **Details of the governance process:** Which committees are responsible for the review of such transactions? How well experienced are committee members in appraising risk transfers when executed through a complex structuring mechanism? How have the personnel involved in these committees gained comfort that the appropriate analysis has been carried out and that all the relevant risks have been incorporated into their consideration?

- **Strategic vs tactical vs transactional:** What are the institutional drivers for the execution of SRT transactions and how do these drivers align with supervisory dialogue on balance sheet and/or business management? Who are the senior stakeholders supporting the execution of transactions and what are their plans for further execution?

- **Existing portfolio management expertise:** How well are the assets being securitised understood by key stakeholders within the regulated firm? What competence exists within the regulated firm to scrutinise and monitor any risk transformation that may occur through the transaction structure?

- **Operational capabilities:** The requirement to monitor the fulfilment of SRT requirements on an on-going basis is likely to identify resource gaps from both an intellectual property and personnel perspective as well as from a systems and models development and deployment perspective. Firms anticipating executing transactions for regulatory capital relief, ought to consider how they will best identify and address such gaps, prior to engaging with NCAs, who have noted that they are not in the business of providing extensive regulatory advice, particularly as the CRR is binding on regulated firms and not on the NCAs.

While the above points are not an exhaustive list of considerations, it is pertinent to remember that these stand alongside the need to demonstrate a clear and confident capability to apply the correct regulatory risk weights and compute the correct corresponding capital requirements. Originator institutions therefore ought to give equal importance and consideration to the qualitative as well as quantitative aspects of the whole life of an exposure, that may at some time become the subject of an SRT transaction.



Conclusions

SRT if done correctly should not be considered impossible.

The relatively long standing position of UK regulatory authorities, and the relatively recent moves by the EBA and ECB-SSM to enhance the scrutiny applied by NCAs on SRT transactions, both point to a period that will involve an increased regulatory burden. Although this burden appears to be driven by a commendable consensus amongst European regulators to support the re-emergence of a robust and credible European securitisation market as part of the Capital Markets Union (CMU). With such a supportive regulatory stance on securitisation markets, firms may wish to consider if they intend to participate in reviving securitisation markets, either as a consequence of their appetite to broaden their fund-raising and risk distribution channels or because they may have need of such a financial instrument in their future strategy. With this in mind, some key preparatory efforts may be worth considering:

Preparing for additional regulatory burden: The extent of the added burden will be dependent upon the nature of analysis and governance currently undertaken by regulated originator institutions and how easily this analysis can be adapted for presentation to NCAs. With the aim being to allow NCAs to be satisfied that all relevant considerations have been made by appropriately accountable individuals within regulated originator institutions.

Mapping and documenting existing governance: NCAs may be interested in existing business-as-usual processes for risk appraisal, on-boarding and management and the process of maintaining up to date documentation is essential. Information that might be typically sought could include details of existing committee structures, the nature of any delegated authority procedures and mechanisms by which comprehensive risk identification is undertaken. With a focus on SRT transactions, firms may wish to anticipate which segments of the existing governance are relevant to regulatory consideration of SRT determination.

Data gathering: Discussion of asset and tranche level losses is an integral part of the regulatory SRT scrutiny. Availability, collation and analysis of such information and a clear demonstration of understanding the prevailing drivers can make the difference between certain NCAs continuing to consider the SRT achieved or to damage regulatory confidence in the capabilities of the originator firm.

Economic analysis tools: Reliance on measuring the level of capital relief against changes in RWEAs as the sole measure of risk transfer, will likely damage the credibility of firms submitting SRT notifications. The development and articulation of a firm's own internal risk and capital assessment mechanisms is essential. As expressed in the CRR, the EBA guidelines and the PRA supervisory statement, firms are at liberty to consider which of the credit risk appraisal techniques they wish to use. These may include the construction and application of stress tests to appraise the vulnerability of assets, and structures to variables such as Probability of Default, Loss Given Default, Exposure at Default, and Potential Future Exposure.

For firms across the UK and EU, the EBAs efforts have begun to create a level playing field for capital relief transactions. These efforts may raise what seem like insurmountable hurdles on the regulatory horizon, however given regulatory efforts to support the securitisation markets and to facilitate lending to the real economy, the regulatory intention is clearly not to block well-structured and well-articulated capital management strategies from being deployed. Therefore SRT if done correctly should not be considered impossible.

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