

**Securitisation: reducing risk
and accounting volatility**
IFRS 9 and significant risk transfer

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Executive summary



The introduction of IFRS 9¹ for European banks hasn't had as severe an impact on banks capital ratios as was initially feared by many analysts. This can be principally attributed to its introduction at a benign point in the economic cycle, which along with central banks quantitative easing has led to loans performing well over recent years.

As the global economy enters a rising interest rate environment as a consequence of changes in the economic cycle, the good loan performance observed in recent years may deteriorate. The pro-cyclical effects of IFRS 9 in future downturns has the potential to trigger significant increases in provisioning, which will directly result in greater P&L volatility and lower capital ratios for banks.

For certain credit portfolios on banks balance sheets this may become an acute problem, both in terms of

P&L impact and level of regulatory capital required. This paper highlights one possible solution to this; properly structured securitisation transactions present an opportunity to mitigate IFRS 9 loan loss provisions, with the potential to result in:

- Reduction of P&L volatility arising from the loan loss provisions
- Reduction in risk weighted assets by achieving regulatory capital relief via significant risk transfer
- Full / partial de-recognition of assets from a bank's balance sheet

On their own any of these three outcomes are potentially attractive, together they become even more compelling. This paper outlines how this might be achieved and some of the considerations required.

Properly structured securitisation transactions present an opportunity to mitigate IFRS 9 loan loss provisions.

1. IFRS 9 Financial Instruments

Impact of IFRS 9 on Banks

Background to IFRS 9

In the wake of criticism of the IAS 39² 'cliff edge' approach to loan loss provisions, one of the desired effects of IFRS 9 was to make accounting provisions more proactive and forward looking. This was principally achieved by requiring accounting provisions to be based on an expected loss recognition model rather than one of incurred losses, thereby resulting in accounting provisions typically being recognised earlier in the credit cycle than previously under IAS 39. Importantly, the overall loss recognised over the life of the loan under IFRS 9 will be the same as that under its predecessor IAS 39.

Classification of loans under IFRS 9

Under IFRS 9 debt instruments are classified in one of three categories, amortised cost, fair value through other comprehensive income (FVTOCI), and fair value through profit and loss (FVTPL). This classification is dependent on whether the cash flows are solely payments of principal and interest (SPPI) as well as the entity's business model for holding the assets.

Business model	SPPI qualifying cash flows?	Classification basis	Expected Credit Losses (ECL) relevant?
Hold to collect	Yes	Amortised cost	Yes
	No	FVTPL	No
Hold to collect and sell	Yes	FVOCI	Yes
	NO	FVTPL	No
Neither of the above	N/A	FVTPL	No

Provisioning under IFRS 9

For the majority of banks their credit portfolios are held at amortised cost, meaning they are recorded at cost plus/minus accumulated amortisation less any provisions. The general IFRS 9 impairment model categorises loan performance into three distinct stages which effect the level of provisions required.

Stage	Status	Provision required
1	Performing	12 month ECL
2	Significant increase in credit risk	Lifetime ECL
3	Credit event has occurred	Lifetime ECL

A significant increase in credit risk is what prompts the change in classification from Stage 1 to Stage 2 and is therefore what triggers the requirement for increased provisions. However, it is the ability for loans to move between stages and the forward looking nature of the model which creates scope for significant volatility in the provisioning as illustrated below.



The impairment movement from Stage 1 to Stage 2 and vice versa creates P&L volatility that is new to banks. This crystallises contingent risk on the balance sheet of regulated banks, introducing volatility to regulatory capital. The level of volatility will be amplified under stress.

Effect of IFRS 9 on banks

As most credit portfolios are held at amortised cost the immediate consequence of this change from incurred to expected losses is an increase in provisions over the short to medium term. However, given the benign economic environment post crisis, the impact to date has not been as significant as had been initially expected. However, this may change with the economic cycle.

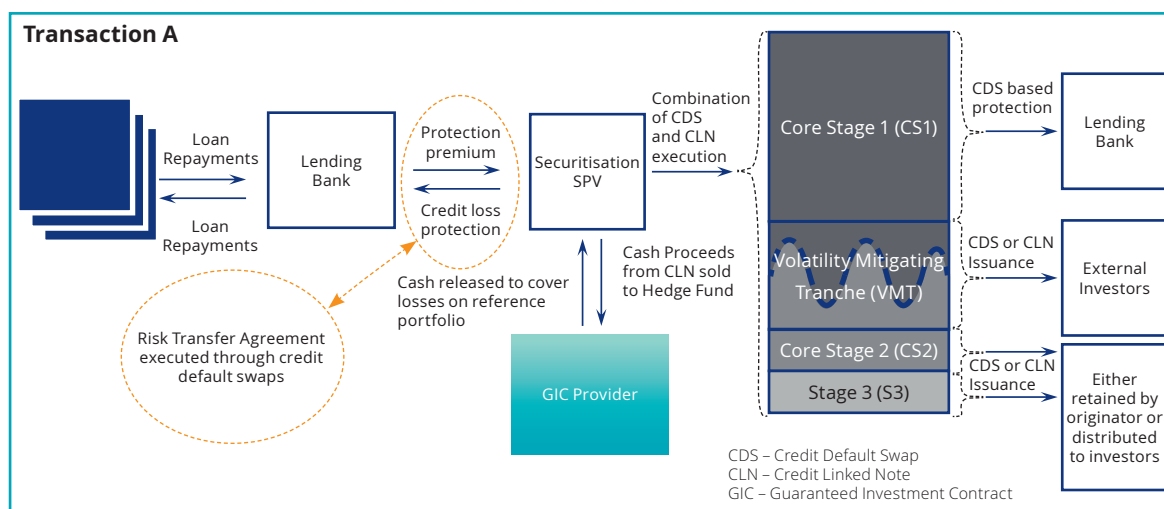
The impairment movement from Stage 1 to Stage 2 and vice versa creates P&L volatility that is new to banks.

2. IAS 39 Financial Instruments

Mitigating IFRS 9 volatility with securitisation

Some of the most profitable credit portfolios for banks to hold may also be the most volatile from an accounting perspective. While the financial returns are attractive, a bank may also find it attractive to mitigate this IFRS 9 volatility. One way of doing this is potentially

via synthetic securitisation, where a segment of the portfolios risk is transferred to investors. The diagram below provides an illustrative example of a synthetic securitisation which may be able to achieve this.



How would Transaction A work?

Synthetic securitisation works by using credit derivatives to provide protection against credit losses on a reference portfolio of assets. In order to achieve this the derivative(s) are structured in such a way that their value changes relative to the provisions. This means the credit derivative provides an asset to mitigate the expected losses of the protected segment thus reducing the P&L impact of the provisions.

In this particular example the portfolio has been tranching on the basis of the IFRS 9 stages, with attachment points based on probabilities of migration rather than traditional levels of credit enhancement, and a volatility mitigating tranche has been created to capture the segment of the portfolio which will fluctuate between Stage 1 and Stage 2. The VMT mitigates the volatility arising from ECLs such that a P&L gain is recognised if there is an increase in ECL. Such an increase could occur if there is a change in assets from Stage 1 to Stage 2. Generally, a P&L gain will be recognised to the extent that the ECL on the reference assets will ultimately be reimbursed by the structure thereby providing a degree of P&L offset. The release of cash by the VMT provides the necessary collateral for credit mitigation purposes.

Credit derivatives and insurance contracts

One drawback to using derivatives is that they need to be fair valued, which potentially introduces a different source of volatility.

One of the concepts that underpins accounting is that of substance over form, which requires one to look past legal form and examine the substance of transactions and core definitions for the purposes of accounting classification.

It follows that a credit protection instrument that takes the legal form of a derivative may meet the accounting definition of an insurance contract. Under IFRS, insurance contracts held are not fair valued and instead policy holders recognise gains when they are 'virtually certain' to be received under the terms of the contract thereby avoiding derivative volatility.

Reducing regulatory capital requirements via securitisation

In addition to reducing a bank's P&L volatility through an IFRS 9 hedging transaction, if structured correctly, the same transaction could simultaneously also be used to reduce a bank's regulatory capital requirements via significant risk transfer (SRT).

Regulatory Requirements

In order to achieve significant risk transfer a bank needs to meet the criteria set out in CRR³ Articles 243 and 244. The most straightforward of these are the "quantitative tests" which are outlined in the box opposite.

While the quantitative tests are generally well understood by most participants in the European SRT market, what is now receiving increased focus is regulatory scrutiny around commensurate risk transfer. The short passage in the CRR on commensurate risk transfer was considered fairly innocuous by most, and few NCAs placed emphasis on, but it is now being given renewed prominence by other European bodies such as the EBA, who in their September 2017 paper⁴ made suggestions regarding how commensurateness might be assessed in a standardised fashion across European banks. This raises the prospect of greater application of a commensurateness test across the EU.

Commensurate Risk Transfer

In its simplest terms, commensurate risk transfer aims to assess the transfer of risk versus the transfer of RWEAs that the selling bank is trying to achieve.

Mathematically this might be expressed as

	Pre	Post	% change in measure
Risk Measure	a_1	a_2	$\alpha = (a_1 - a_2)/a_1$
RWEA	b_1	b_2	$\beta = (b_1 - b_2)/b_1$

Where the level of risk transfer sought is equal to the min (α , β)

Successful SRT will remove the protected tranches from the selling banks regulatory balance sheet, reducing RWEAs and saving the associated capital.

Achieving SRT

Given the CRR definition of mezzanine tranches it is unlikely that purchasing protection on just the VMT tranche in Transaction A would meet the quantitative tests set out in the CRR. Meaning that protection on the CS2 and S3 tranches would likely be necessary. Therefore, another important consideration in achieving SRT is implicit credit support. Taking the example of Transaction A, an issuer would likely need to protect both the CS2 and S3 tranches to achieve SRT, as if an issuer protected just the VMT and CS2 tranches while also having control over loan foreclosures and workouts etc. then the issuer could potentially provide credit support to CS2 investors by reassuming the risk in the S3 tranche.

Therefore provided the transaction is properly structured it is possible to achieve regulatory capital relief alongside removing the P&L volatility created by IFRS 9 provisioning of a credit portfolio.

It is possible to achieve regulatory capital relief alongside removing the P&L volatility created by IFRS 9.

3. CRR, June 2013

4. EBA Discussion Paper, September 2017

The mechanics of the quantitative tests

Subparagraph (2) of each of articles 243 and 244 outline what have come to be referred to by market participants as the "quantitative 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.

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

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.

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

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

Reducing leverage through accounting de-recognition

The vast majority of post-crisis European securitisations have been on balance sheet for accounting purposes. This includes even those that have achieved some degree of significant risk transfer and which have been derecognised in part from the regulatory balance sheet. The potential benefit from achieving accounting de-recognition could be significant subject to the illustrated considerations around the determination of the leverage ratio.

The path to accounting de-recognition

Accounting de-recognition is linked principally to three factors, a) a qualifying transfer of cash flows, b) the transfer of risk and reward, and c) transfer of control. If, in a qualifying transfer, risk and reward substantially transfers to a third party then it is that third party which recognises the assets on its balance sheet. In practice transfer of $\geq 90\%$ of the variability of returns to a third party is likely to result in a transfer of substantially all risks and rewards. At which point the transferor can derecognise the assets. In the case of a securitisation where only part of the structure such as a particular mezzanine tranche is protected for instance, this might create a situation whereby an entity has neither transferred nor retained substantially all of the variability of the returns, this leaves a question about how to recognise a partial transfer of risk and reward. The diagram below outlines four possible scenarios with regards to transfer of risk and reward.

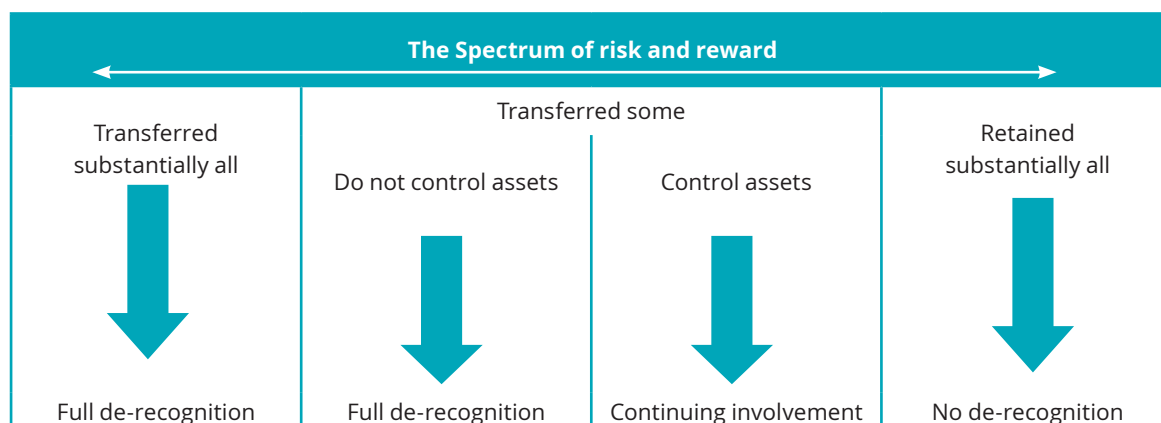
Continuing involvement

In a situation whereby an entity has neither transferred nor retained substantially all of the risks and rewards, then de-recognition is required if the seller no longer controls the loans. However, this is often difficult to demonstrate for loan assets for which there is no active market and the buyer has the benefit of a risk sharing agreement with the seller. Accordingly, when control is retained, the continuing involvement approach should be applied. This results in the entity continuing to recognise an asset together with a new liability that, together, capture the rights and obligations retained rather than the whole portfolio. Therefore, in a SRT transaction where part of the risks and rewards have been transferred to a third party, but control retained, a seller is able to account for this under continuing involvement. While this isn't as advantageous as full off balance sheet treatment, partial de-recognition is still valuable, particularly in a world where banks are increasingly conscious of their leverage ratio.

Upcoming changes to the definition of mezzanine tranches in the CRR

From 1 January 2019 the CRR⁵ will define mezzanine tranches as *"a position in the securitisation which is subordinated to the senior securitisation position and more senior than the first loss tranche, and which is subject to a risk weight lower than 1250 % and higher than 25 %"*

The removal of CQS from the definition mezzanine will not only broaden the definition of mezzanine tranches but also broaden what qualifies as senior tranches. This will allow assets which could not achieve the necessary credit quality step to be used in transactions post 2018.



5. CRR Amendment, REGULATION (EU) 2017/2401, December 2017

Next steps

Impact of IFRS 9: Given the benign economic environment that IFRS 9 was introduced in, its effect on banks has been muted. However, when the economic cycle turns, IFRS 9 is expected to result in much earlier loan loss provisioning than IAS 39, creating the potential for P&L volatility.

Mitigating IFRS 9 volatility: Securitisation provides a potential mechanism for mitigating the volatility, through transactions structured to transfer to investors the P&L volatility which occurs as a result of the movement of loan exposures from Stage 1 to Stage 2 and vice versa. The transaction outlined in the paper is one potential solution to achieve this.

Optimising the balance sheet: When considering a strategy to reduce the volatility from IFRS 9 provisioning, banks may wish to consider simultaneous opportunities to optimise their balance sheet. Along with the potential to mitigate IFRS 9 volatility, securitisation also provides scope to potentially reduce a) the risk weighted assets, and b) the leverage ratio of banks. Banks that are interested in these outcomes should be mobilising internally now in order to get ahead of their competitors.

How Deloitte can help: We can support in a number of ways, these include,

- Working alongside firms who wish to execute transactions of this type
- Helping provide preliminary challenge to development of structural features, from both an investor and regulatory perspective
- Provide input to the technical accounting considerations of such transactions.

When considering a strategy to reduce the volatility from IFRS 9 provisioning, banks may wish to consider simultaneous opportunities to optimise their balance sheet.

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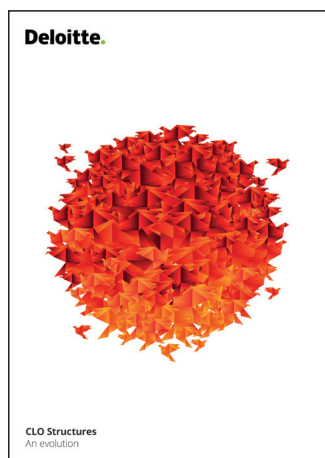
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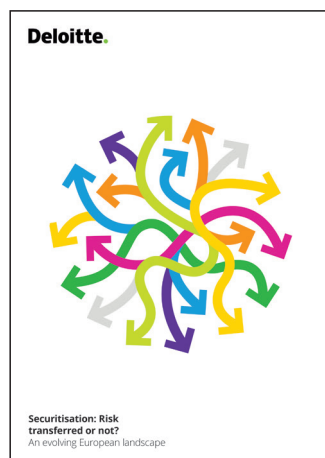
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An Evolution



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An Evolving European Landscape



Securitisation Investor Due Diligence
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