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CP12-18
Prudential Regulatory Authority
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Response to CP12/18 "Securitisation: The new EU framework and Significant Risk Transfer"

On behalf of the Association for Financial Markets in Europe ("**AFME**")[1], the International Association of Credit Portfolio Managers ("**IACPM**")[2] and UK Finance[3] (together with AFME and IACPM, the "**Joint Associations**") and their members, we welcome the opportunity to respond to consultation paper CP12/18 "Securitisation: The new EU framework and Significant Risk Transfer" (the "**CP**") published by the Prudential Regulation Authority (the "**PRA**") in May 2018.

We have the following comments prompted by our review of the CP.

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1 AFME represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1 November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association. AFME provides members with an effective and influential voice through which to communicate the industry standpoint on issues affecting the international, European and UK capital markets. AFME is the European regional member of the Global Financial Markets Association (GFMA) and is an affiliate of the US Securities Industry and Financial Markets Association (SIFMA) and the Asian Securities Industry and Financial Markets Association (ASIFMA). AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

2 The IACPM is an industry association established to further the practice of credit exposure management by providing an active forum for its member institutions to exchange ideas on topics of common interest. Membership in the IACPM is open to all financial institutions worldwide that manage portfolios of corporate loans, bonds or similar credit sensitive financial instruments.

The Association represents its members before regulatory and administrative bodies in the US and internationally, holds bi-annual conferences and regional meetings, conducts research on the credit portfolio management field, and works with other organizations on issues of mutual interest relating to the measurement and management of portfolio risk.

Currently, there are 103 financial institutions worldwide that are members of the IACPM. These institutions are based in 19 countries and include many of the world's largest commercial wholesale banks, investment banks and insurance companies, as well as a number of asset managers.

3 UK Finance represents nearly 300 of the leading firms providing finance, banking, markets and payments related services in or from the UK. UK Finance was created by combining most of the activities of the Asset Based Finance Association, the British Bankers' Association, the Council of Mortgage Lenders, Financial Fraud Action UK, Payments UK and the UK Cards Association. Our members are large and small, national and regional, domestic and international, corporate and mutual, retail and wholesale, physical and virtual, banks and non-banks. Our members' customers are individuals, corporates, charities, clubs, associations and government bodies, served domestically and cross-border. These customers access a wide range of financial and advisory products and services, essential to their day-to-day activities. The interests of our members' customers are at the heart of our work.

1. *Uncertainty with respect to capital calculations*

As pointed out by the PRA in the CP, the new EU framework being brought in by the Securitisation Regulation (the "**SR**") and associated amendments to the Capital Requirements Regulation (the "**CRR**") leaves a significant degree of discretion for national competent authorities ("**NCAs**") to deviate from the general hierarchy of approaches set out in Article 254 CRR. In particular, Article 254(4) gives NCAs the ability to prohibit institutions from applying the SEC-SA on a case-by-case basis. Similarly, Article 258(2) gives NCAs the ability to prohibit institutions from applying the SEC-IRBA on a case-by-case basis. In both legislative provisions, reference is had to the presence of "highly complex or risky features" as the primary reason for exercising these discretions, although the discretion to disallow the use of the SEC-SA is admittedly broader, covering any reason the RWEAs under the SEC-SA are not commensurate to the risks posed to the institution or financial stability.

That said, the CP in its section titled "PRA discretions on the hierarchy of methods" (beginning with paragraph 3.24) appears to conflate the discretions provided by the CRR, saying that "[a] risk to safety and soundness may arise where risk weights arrived at under the SEC-SA or SEC-IRBA result in Pillar 1 capital requirements which do not reflect the risk posed to the firm". It goes on to say that, in such cases the SEC-ERBA may provide a more appropriate estimation of risk. There are further statements that appear to conflate the reasons available for exercising the two discretions such as paragraphs 4.5 and 4.8 of the draft supervisory statement.

With respect, we believe the approach proposed by the PRA in the CP and the attached draft supervisory statement is incorrect. In this respect, it is worth remembering the context in which the current changes are being made. That is to say, the PRA has had guidance outstanding since 2013 (in the form of SS 9/13) requiring ratings for the calculation of securitisation RWEAs in SRT transactions. This was one way of benchmarking banks against each other. That guidance is consistent with the current approach to securitisation capital calculations but the attitude favouring external ratings as the most appropriate or reliable way to determine appropriate risk-weighting is not consistent with the CRR as amended in the context of the revised securitisation framework. The Basel Committing deliberately demoted the SEC-ERBA down the hierarchy and the European authorities demoted it further, placing it at the bottom of the hierarchy in most circumstances. Accordingly, members of the Joint Associations are of the view that the PRA's approach to exercising the discretions in 254(4) and – especially – in Article 258(2) should be sparing, and should not be benchmarked based on what the outcome would be under SEC-ERBA. Otherwise, a principal purpose of the changes to the hierarchy made in the amended CRR would be subverted.

This change is also no accident. The European legislators had evidence that the SEC-IRBA and SEC-SA would frequently produce much less conservative results than the SEC-ERBA when deciding on the appropriate hierarchy. This evidence included the European Banking Authority's January 2014 report on qualifying securitisation[4], which shows very clearly the non-neutrality of the various approaches to calculating capital. Figure 24 (page 104) of that report shows that SEC-ERBA is both more conservative (sometimes much more conservative) and that the non-neutrality ratio for the SEC-ERBA reduces much less for STS transactions than it does using either SEC-IRBA or SEC-SA. Also brought to the European

[4] https://www.eba.europa.eu/documents/10180/950548/EBA+report+on+qualifying+securitisation.pdf

authorities' attention in the context of the legislative process was a paper[5] published in October 2015 by William Perraudin, Alexandre Linden and Georges Duponcheele, which reproduces the EBA evidence, expands on the reasons the SEC-ERBA approach is prohibitively conservative and discusses ways in which this might be addressed. It was in the light of this evidence that European legislators chose to "invert" the hierarchy and put the SEC-ERBA at the bottom (which is one of the solutions suggested in the paper). To treat the SEC-ERBA as a benchmark or "gold standard" for the amount of capital that should be held against a securitisation position in this context is therefore clearly inconsistent with the legislative intention.

This is not to say that the SEC-ERBA can never provide a more appropriate risk-weight than the SEC-SA and/or SEC-IRBA, but the appropriate way to measure this is not simply to compare the outcomes from each of the three methods, which creates a bias in favour of the method that produces the highest risk-weight (usually the SEC-ERBA). Rather, the specific characteristics of the portfolio and transaction structure (discussed below) should be evaluated to determine whether the SEC-IRBA or SEC-SA risk-weight is appropriate and necessary adjustments (if any) agreed by the relevant firm with the PRA in a manner that takes account of the relevant circumstances. In light of this, the guidance should clarify that the default position is not to compare the risk-weight generated by the SEC-SA and/or SEC-IRBA formulae with that which would apply under the SEC-ERBA approach, and therefore there is no presumption that banks are required to solicit such external ratings for this purpose. Rather, such benchmarking of the SEC-SA/SEC-IRBA risk-weights against the SEC-ERBA outputs would only be appropriate in circumstances of arbitrage or in circumstances, such as those discussed in the following paragraphs, where there are specific reasons for concluding that the SEC-SA or SEC-IRBA formulae are inappropriate for the relevant transaction.

In addition to the basic conceptual objection to benchmarking against the approach that is lowest in the hierarchy (and, implicitly, requires the highest capital because it is least risk-sensitive), there are the very practical issues of cost and timing. Obtaining a rating from an ECAI for a transaction is a lengthy and expensive process, often costing several hundred thousand pounds (plus an annual rating maintenance fee of tens of thousands of pounds) and taking months. When combined with Article 8c of the Credit Rating Agencies Regulation (which requires at least two ratings wherever a rating is solicited for a securitisation instrument), a policy implicitly requiring benchmarking against SEC-ERBA will usually result in additional transaction costs of over £1 million per transaction. From the timing point of view, this policy means that transactions simply would not be able to be executed quickly, even where the commercial parties are able to quickly analyse and agree the transaction. This, in turn, will create an unlevel playing field by putting UK banks at a competitive disadvantage as compared to other global banks who – by and large – will not be required to get ratings.

The CP and draft supervisory statement note that there are risks not explicitly captured by the SEC-SA and SEC-IRBA formulae, such as market risk (rates and foreign exchange), single name concentrations, and more highly correlated pools, but they fail to acknowledge that these limitations were taken into account through a conservative calibration (the formula-based methods, for example, do not provide any risk-weight reductions to account for the

[5] http://www.riskcontrollimited.com/wp-content/uploads/2015/10/Comments-on-the-Commission%E2%80%99s-Proposals-for-Reviving-the-European-Securitisation-Market.pdf

protection provided by excess spread). We therefore disagree with the apparent implication in the CP that the failure of the SEC-SA and SEC-IRBA formulae to capture these risks explicitly is always problematic, and raises a concern that the PRA intends to exercise its discretions to disallow the use of the SEC-IRBA and SEC-SA to calculate capital in a wider range of circumstances than would truly be appropriate.[6] This would be unjustified. A diversified portfolio, with normal amounts of risk of this nature, would not typically be insufficiently capitalised – especially as the PD and LGD inputs will have been signed off by the PRA. To provide appropriate balance, the guidance should acknowledge that the mere fact that a transaction may have some risks of this nature does not, on its own, justify an override of SEC-IRBA or SEC-SA (indeed most securitisations will have some risk of this type). As discussed above, the lawmakers cannot have intended the override to apply so broadly.

It should similarly be acknowledged that the presence of individual transactions, within a balanced portfolio, which exhibit elevated levels of this type of risk, should not also not be problematic. It is intrinsic in the SEC-SA that portfolios will include some transactions with risk weights lower than their true risk. The SA is calibrated to be a reasonably conservative approach on a portfolio level.

Application of the power to override SEC-SA and SEC-IRBA is, of course, justified in cases of complex and artificial structuring which is designed to exploit deficiencies in the formulae in a manner which is inconsistent with prudent capital management, but beyond that it should be used sparingly. The override of SEC-IRBA in Article 258(2) arises only in the case of highly complex or risky features, and in the case of the SEC-SA override this is also indicated as the main purpose of the override (although we acknowledge a wider scope for use of this power in the text of the CRR). An important purpose of having standard formulas such as SEC-SA and SEC-IRBA is to produce RWEAs which are consistent between institutions and EU jurisdictions, thus aiding comparability. In exceptional circumstances where, due to the imperfections of these formulas, combined with the particular shape of a bank's portfolio, the total formula-based RWA is too low, an adjustment should be agreed between the firm and the PRA to appropriately reflect the risk of the relevant exposure. Members of the Joint Associations would expect in general that such adjustments could be made as voluntary increases in capital held under Article 3 of the CRR, thus obviating the need for an exercise of Article 258(2) or Article 254(4) discretions.

These principles can be illustrated by the following examples. It would be helpful to have similar examples in the final supervisory statement to clarify the general approach:

- A bank has a balanced portfolio of unrated securitisations which are risk weighted using SEC-SA. Within the portfolio are some transactions with significant concentration risk. These transactions are structured on normal market terms for the asset class. These concentration risks are not explicitly captured by the SEC-SA formula, and the conservatism built into the formula may not be sufficient to cover this on a transaction by transaction basis. However, the bank's ICAAP assessment takes account of this risk and the bank is able to demonstrate that the capitalisation of the portfolio as a whole is appropriate.

  Conclusion: no adjustment of any sort is appropriate.

[6] The list of characteristics in paragraph 4.10 of the draft new supervisory statement also suggests that there may be a tension with e.g. the STS criteria that require pool homogeneity.

- As above, but the portfolio, for commercial reasons, happens to have a relatively high weighting of transactions with concentration risk and other risks which are not explicitly captured. The ICAAP assessment (or PRA review) concludes that the capital charge across the portfolio is too low. The transactions concerned are structured on normal market terms, without unusual structural features. The uncaptured risk simply reflects the fact that certain risks are not reflected in the SEC-SA formula, and the portfolio happens to have more of those than average.

  Conclusion: to aid comparability with other institutions, SEC-SA should continue to be used, but the under-capitalisation should be corrected through a voluntary increase in capital under Article 3 of the CRR agreed with the PRA.

- As above, but some of the transactions have features which are highly non-standard: certain structural features appear to have been designed to artificially increase the attachment point, without a commensurate reduction in risk, to arbitrage the SEC-SA formula.

  Conclusion: the use of the SEC-SA formula it this case is inappropriate and misleading and does not promote comparability. In this case the SEC-SA override should be applied.

Finally, members of the Joint Associations are concerned that any exercise of discretion under either (or both of) Article 258(2) or 254(4) should be made prior to execution of the transaction. Since capital considerations are often central to determining the economic viability of a transaction, and the choice of approach will have a significant impact on the capital charge associated with a transaction, the availability of the SEC-IRBA and/or SEC-SA is in effect a key commercial term for the bank when deciding whether to enter into the transaction. A determination later in the process may require a costly early unwinding of a transaction previously entered into on the assumption that the SEC-IRBA or SEC-SA would be available. What is more, it is often impractical or impossible to obtain a rating after a transaction has been executed, meaning that – where both the SEC-IRBA and SEC-SA are unavailable, the relevant securitisation position would automatically be risk-weighted 1250% which is obviously an undesirable outcome which will in most cases be unreflective of the genuine risk of holding the position.

2. *Difficulties with providing information in the time allotted*

Members of the Joint Associations note that the PRA may request further information from a firm and that the expectation is that this will generally be provided within 20 business days. In many cases this may be appropriate, but members of the Joint Associations note that, depending on the nature of the further information requested and how easy it is from a systems perspective for the bank to compile that information, this timeframe may not be realistic in all cases. For example, firms' systems are generally designed to record and report information they expect to be required by regulators. If the information requested is of an unexpected type, or needed in an unexpected format, the process of extracting, validating, and signing off the information could be longer than 20 business days. Needless to say if the "further information" required is a rating, it is highly unlikely that that information could be obtained within 20 business days unless the rating already exists (or is already in the process of being produced).

Members of the Joint Associations would therefore request that paragraph 4.13 of the draft supervisory statement be amended to say "The PRA expects firms to provide this information within 20 business days **where reasonably practicable**, unless agreed otherwise."

In addition, members of the Joint Associations are concerned at the suggestion that for ICAAP reporting purposes they will be required to provide the same level of information about all securitisations which they hold, rather than just in relation to those where they act as originator. For many banks, this could mean onerous reporting on hundreds of invested positions and, particularly in light of the comments raised in the preceding point, could be unworkable. This is especially true if trading book positions are included, as these are, by their nature, held for comparatively short periods of time.

If these ICAAP reporting changes are to be introduced, members of the Joint Associations would request that further guidance is given in respect of grandfathering and transitional issues. Some positions will pre-date both the financial crisis and the any new rules requiring these types of disclosures, so adjustments will be needed in order to make the ICAAP requirements workable in this context.

3. Uncertainty with regard to powers and regulators

The CP correctly notes that there are a number of discretions that HM Treasury will need to exercise with respect to the designation of NCAs for various purposes described in paragraph 2.4 of the CP. While we are aware that this is beyond the powers of the PRA, members of the Joint Associations would note that it is very important for market predictability and preparation that the designation of such authorities should be completed as quickly as possible. This is necessary in order that any further guidance issued by the relevant designated NCAs should be consulted upon and finalised prior to the application of the SR on 1 January 2019.

4. Uncertainty with regard to grandfathering

Article 2 of the CRR Amending Regulation (Regulation (EU) 2017/2401) is clear that, in respect of legacy securitisations, "institutions **shall** continue to apply the provisions set out in [the CRR prior to its amendment]" (emphasis added). However, paragraph 3.20 of the CP says that "securitisations in which the securities were issued before Tuesday 1 January 2019 **may** continue to apply the current CRR securitisations capital framework" (emphasis added). members of the Joint Associations believe this is just an error, as the PRA does not have power to amend the text of the CRR to make the grandfathering optional, but we would be grateful if the PRA could confirm the position.

5. Uncertainty arising from Brexit

One area that is not addressed in the CP is the actions the PRA will take (if any) to address the consequences of Brexit. HM Treasury has announced its intention (subject to Parliamentary approval) that, under some circumstances, the PRA will be given extensive rule-making powers to adjust the EU *acquis* following Brexit. We understand that these powers will be consulted upon separately in the autumn, so at this stage we would simply request that the securitisation framework be taken into account when any such consultation is launched. That consultation would presumably be the place to address issues such as the recognition in the UK of EU27 STS status, the requirement for EU-establishment (presumably to become UK-establishment) of various securitisation market actors etc. in order to ensure a more open, less protectionist UK securitisation market.

6. Clarifications with respect to the due diligence obligations under Article 5 SR

As a threshold issue, we note that the focus on investment activity in paragraph 2.9 of the CP is helpful. We consider that this makes sense and is consistent both with the historical approach to determining when banks' securitisation due diligence obligations are triggered and with the focus on assumption of credit risk in the current risk retention RTS (that has been maintained as Articles 2(1) and 2(2) in the EBA's final draft RTS issued on 31 July 2018[7]).

In addition, members of the Joint Associations note that there has been some uncertainty around due diligence obligations generated by the lack of provision for guidelines or technical standards around the Article 5 SR diligence obligations. This guidance has, of course, historically been provided by the CEBS Guidelines and then by the "risk retention" RTS[8]. In particular, Article 19 of the existing risk retention RTS has been very helpful in clarifying for banks that they are permitted to take a proportionate approach to their due diligence obligations.

While Article 5(4) SR (which relates to ongoing due diligence requirements) refers to procedures proportionate to the risk profile of the position and, where relevant, to the investor's trading and non-trading book, the available application of this concept of proportionality is far less clear in the context of the initial/pre-investment diligence obligations under Articles 5(1) and 5(2) SR. Helpfully, recital (9) talks about proportionate due diligence in general, but it would be preferable to have specific guidance from the PRA as the competent authority responsible for supervising these obligations to the effect that the proportionate approach to diligence currently permitted under Article 19 of the existing risk retention RTS will continue to be allowed. At the moment, proposed paragraph 2.9 of the draft supervisory statement refers only to firms having "adequate" due diligence arrangements, processes and mechanisms to ensure compliance with Article 5 SR.

Accordingly, members of the Joint Associations would request that the current Article 19 of the risk retention RTS be carried over into the final supervisory statement and that proposed paragraph 2.9 of the supervisory statement be amended as follows "…that they have adequate due diligence arrangements, processes and mechanisms that are proportionate to the risk profile of the securitisation position and, where relevant, to the institutional investor's trading and non-trading book, in order to ensure compliance with Article 5 of the Securitisation Regulation."

[7] http://www.eba.europa.eu/documents/10180/2298183/Draft+RTS+on+risk+retention+%28EBA-RTS-2018-01%29.pdf

[8] Commission Delegated Regulation (EU) 625/2014.

7. Uncertainty arising from amendments to Article 7 SR

The disclosure requirements of the SR in general require that information be made available to investors, competent authorities and, upon request, potential investors. Given that the "upon request" clause appears on its face to apply only to potential investors, this raises the question of what reporting under Article 7 SR is expected to be made to the NCAs on a regular basis in the absence of a specific request. For public transactions, members of the Joint Associations assume that reporting to a securitisation repository pursuant to Article 7(2) SR will be sufficient, but would appreciate the PRA confirming the position. In addition, members of the Joint Associations would request that the PRA confirm what reporting to the PRA will be expected on private transactions where no reporting is done to a securitisation repository.

8. Uncertainty arising from amendments to Article 14 CRR

Article 14 CRR applies certain EU securitisation rules to EU-established financial groups on a consolidated basis. It was amended by the CRR Amending Regulation in a manner which rendered it simultaneously much more far-reaching and also caused it to be drafted in a nonsensical way that was, in many respects, impossible to apply. It has been widely acknowledged that the expansion in scope of Article 14 was an accident and, consequently, amendments to Article 14 have been proposed and are expected to be published in the Official Journal as part of the risk reduction package of CRR2 currently in trilogues. However, publication of the CRR2 risk reduction package in the Official Journal is unlikely to take place in time to avoid the application of the inappropriately expanded Article 14 on 1 January 2019. There is therefore expected to be a brief period (possibly a period of months) during which the interim, unworkable version of Article 14 will formally be law despite it being clear that that was never the intention of the legislators.

In order to address this awkward situation, members of the Joint Associations would urge the PRA to make clear via a public statement that it does not expect supervised firms to comply with the interim version of Article 14 and will not take enforcement action against firms for the purpose of enforcing the interim version of Article 14.

9. ECAI assessment mapping areas not addressed

An interim mapping of ECAI assessments is provided in Table 1 in the draft supervisory statement. However, not all recognised ECAIs' rating systems are represented in Table 1. members of the Joint Associations would request that the PRA confirm that the mapping table applies to all recognised ECAIs (it appears to currently be silent on this) and provide interim mappings that include the ratings formats used by all recognised ECAIs as well. In particular, the format of DBRS ratings is not included in this table.

10. IAA permissions not addressed

Article 265 CRR provides that a firm may use the IAA if it has permission from its NCA to do so. The CP does not indicate how any existing permissions to use the IAA will be carried across into the new regime. Members of the Joint Associations would welcome clarifications in this respect. We would suggest that existing permissions should be able to be relied upon seamlessly under the new regime. If that is not the PRA's intention, we would request that the PRA clarify the process that will apply to renew such permissions.

11. Significant risk transfer

Members of the Joint Associations note as a general matter that we believe that Part 2 of the CP and the associated proposed amendments to SS9/13 are premature and inappropriate generally. They would appear to have been prompted by the EBA Discussion Paper on SRT which closed for comments on 19 December 2017 (the "**EBA DP**"). The EBA has since then made clear on a number of occasions that the ideas discussed in the EBA DP were not intended to be implemented in the form set out therein and, indeed, that some of those ideas may not necessarily be implemented at all. In addition, some of those proposals may require amendments to the CRR legislative framework, rather than merely representing a change in regulatory guidance. The EBA DP represented the beginning of a conversation among the EBA, NCAs and market participants about potential changes to the SRT system that may or may not be implemented following the feedback to the EBA DP and one or more further consultations on the subject. For NCAs to implement any of the policy proposals articulated in the EBA DP at this stage would risk causing differential treatment among EU Member States, opening up the opportunity for arbitrage and creating an unlevel playing field for EU banks depending on their primary prudential supervisor. While it is surely appropriate for the PRA to keep its policy as concerns SRT under review, this is not an appropriate time to be making changes.

That said, if changes are to be made, we would refer the PRA to the joint AFME and IACPM response to the EBA DP as to the substance of the proposals, as our views are articulated there and apply equally to the PRA's proposed implementation of those ideas. See, in particular, the responses to questions 7 ("general capital treatment" section), 10, 11 (including 11a and 11b), 12, 13a, 13b, 14, 15, 19, 20, 21 and 22. See also the discussion of the commensurateness tests proposed by the EBA in response to their questions 23 and 24 (which we note is different to and more sophisticated than the rather blunt tool of requiring the application of a 1.5x scalar to K_{SA} for the purposes of achieving SRT on a SEC-SA portfolio).

Further, we do not agree with the proposal to require the application of a 1.5x scalar to K_{SA} for the purposes of achieving SRT on a SEC-SA portfolios. This ignores the inherent conservatism already built into the SEC-SA. Further, the underlying assumption behind this proposal would appear to be that firms will lack high-quality data for assessing the underlying portfolio, an assumption that will not normally be justified. Where a firm is able to demonstrate that its RWA reduction is matched by a commensurate transfer of risk to third parties, SRT should be permitted irrespective of the approach applicable to calculating risk-weights on the underlying portfolio. Further, it is not clear how the 1.5x scalar was decided upon and it is unclear how it would be applied to transactions seeking to achieve SRT by selling mezzanine tranches rather than first loss.

An additional point not raised in the AFME-IACPM response to the EBA DP is that a significant anomaly is caused on proposed SRT transactions because CRR risk weights do not recognise differing levels of risk in consumer loan pools, even in the case of IRB assets whose risk weights should be more risk-sensitive. As a result, portfolios with high interest margins will almost always be uneconomic to hedge because the large excess spread position to be recognised would, in almost all circumstances, be so large that it would cause a severe reduction in RWA relief. Also, in the case of high regulatory expected loss portfolios, the problem is exacerbated because of the way the commensurate risk transfer test is designed. This is because any excess spread designed to absorb losses must be deducted from the amount of expected and unexpected losses transferred to investors in ratio 2 of the test, causing the test to be failed on high margin portfolios. The result of this is that high expected loss portfolios cannot be hedged in economically sensible ways because the cost of protection would be excessively high or the commensurate risk transfer test would be failed. The effect of this is to penalise banks for engaging in safe lending by making hedging impractical where the bank ensures that portfolios charge a sufficient margin to cover a bank's expected losses.

We would further note that the emphasis on SEC-ERBA described in our point 1 above has a knock-on effect caused by its interaction with one of the policy ideas described in the EBA DP. That is, at paragraph 102(a)(II), the EBA proposes that the definition of a "regulatory call" (which calls would – along with tax, clean-up and SRT calls – in general be permitted without affecting SRT) should "[e]xclude 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" (emphasis added). While members of the Joint Associations find this suggestion by the EBA problematic in any case, the issue becomes especially acute in the context of a regulatory environment that emphasises the SEC-ERBA. In such cases, it is inconsistent for regulatory policy both to insist on calculating capital on the basis of external ratings and simultaneously deny firms the ability to call the transaction on the basis that (in substance) the relevant rating agency has decided, *ex post facto*, that the transaction no longer transfers quite as much risk to external investors as originally thought.

In addition to the above, we have the following comments on the PRA's proposal to recognise untrapped future excess spread on traditional securitisations, which was not proposed by the EBA:

- If a securitisation position is to be recognised for untrapped excess spread, this leads to double counting of capital because:

    - The non-neutrality built into the risk weightings of securitisation positions, which already add up to more capital than would be required for the underlying assets on an unsecuritised basis. Adding another position without a commensurate lowering of the risk weightings of more senior tranches will only increase the non-neutrality.

    - Related to the above, the SEC-IRBA and SEC-SA formulas, as currently drafted, would not adjust attachment and detachment points to take into consideration the additional securitisation position. Accordingly, on top of the non-neutrality issue raised above, the problem would be exacerbated by overly conservative attachment/detachment points.

  More broadly, it would seem under the prudential filters in Article 32 of the CRR that an originator should not be required to 1250% risk weigh (or deduct) a securitisation position in respect of unrealised (or indeed realised) excess spread where it has excluded a corresponding "gain on sale" from "future margin income" (or, by analogy, excluded a net gain arising from the capitalisation of future income from the securitised assets that provides credit enhancement to positions in the securitisation).

- It is unclear whether the nominal value of the resulting securitisation position, under the PRA's proposal, would be fixed at closing or required to be adjusted on an ongoing basis to reflect excess spread expectations (e.g. in light of prepayments). If the PRA's proposal is to be implemented, this should be clarified. Members of the Joint Associations would suggest fixing this on the basis of lifetime expected losses at closing to aid predictability and planning of transaction costs.

- There are wider policy considerations that may be undermined by this proposal:

  - The political objective of the STS/CRR changes was, in part, to allow banks to use securitisation for its traditional risk transfer purposes. This proposal would have the opposite effect.

  - There is no consideration about the additional cost of protection imposed by this proposal on banks. If members of the Joint Associations choose to sell the excess spread position, this is a direct increase in cost of protection which may cause the deal to be uneconomic. If, on the other hand, members of the Joing Associations choose to keep the excess spread position, the cost of the deal becomes uneconomic because, for every pound spent on paying investors to hole sold tranches, the RWA reduction is less (due to the increased capital charge for the transaction overall caused by making the excess spread a securitisation position), thus raising the cost per RWA reduced to unacceptable levels.

  - There is no consideration about the contradiction of this proposal with the express CRR principle that capital is not required for future income.

12. Slotting and the calculation of RWEAs under SEC-IRBA

Although not strictly an issue raised by the CP, members of the Joint Associations would appreciate if the PRA issued guidance around the methods they are permitted to use to calculate RWEAs under SEC-IRBA for slotted assets following the application of the CRR amendments made by Regulation (EU) 2017/2401 (the CRR as so amended, the "**New CRR**"). Under the New CRR, SEC-IRBA will be at the top of the hierarchy. Within SEC-IRBA, LGDs are needed to calculate a "p" value, which is a key input in the calculation of RWEAs. For certain assets subject to "slotting" under SEC-IRBA, RWEAs are derived from a look-up table rather than using a regulatory LGD input. These include commercial real estate and project finance assets.

In this context, it is not clear to members of the Joint Associations whether they are required to use the 50% LGD prescribed for granular portfolios under Article 259(6) of the New CRR or if they are permitted to use the foundation IRB LGD regulatory inputs as provided in Article 161 of the CRR, which would result in an LGD of either 35% or 45% depending on collateral. In the former case, a further question arises about whether the 50% LGC should apply to the whole reference portfolio or only to the slotted exposures.

As the CRR does not preclude the use of regulatory inputs for slotted exposures, members of the Joint Associations would encourage the PRA to issue guidance to the effect that firms are permitted to use regulatory inputs for IRB portfolios subject to slotting.

13. Tensions in regulatory policy surrounding credit rating agencies

Members of the Joint Associations note that paragraph 3.37 of the CP and proposed new paragraph 4.3 of SS9/13 make reference to the PRA assessing the expertise of the chosen rating agency in the asset class being rated. While we understand that this is in accordance with existing EBA guidelines on SRT, we would note that firms of course conduct their own assessments of credit rating agencies prior to engaging them and firms are required by Article 8d of the Credit Rating Agencies Regulation to consider a smaller agency on each occasion where they engage more than one. Applied too strictly, this assessment of expertise by the PRA could turn cause tensions with existing obligations on firms – a concern which we would request the PRA to bear in mind and reflect in the wording of the revised SS9/13.

In closing, we wish to emphasise that the engagement of the PRA with market participants on issues related to the UK implementation of the new EU securitisation framework and SRT is appreciated. We are grateful for the opportunity to comment on the CP and we would be happy to answer any further questions that you may have.

Yours faithfully

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