High Level Forum on the Capital Markets Union:
A New vision for Europe's Capital Markets

IACPM feedback to the European Commission on
Recommendations 5 (Securitisations)

The **IACPM** (International Association of Credit Portfolio Managers) is a global industry association established in 2001 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.

The IACPM's institutional member firms comprise the world's largest financial institutions, and as such overlap the membership of several other financial industry associations. Our perspective is different, however, in that the IACPM represents the teams within those institutions who have responsibility for managing credit portfolios, including actively controlling concentrations, adding diversification, managing the return of the portfolio relative to the risk and applying capital to new lending.

In carrying out these responsibilities successfully, credit portfolio managers contribute to maintaining the safety and soundness of their respective financial institutions. Effective credit portfolio management is critically important to our prudential supervisors and to policy makers more broadly because of its role in supporting financial institutions' ability to lend.

The IACPM welcomes the proposals of the High Level Forum (the "**HLF**") on the Capital Markets Union ("**CMU**") in relation to securitisation. The proposals address some of the key shortcomings in the current securitisation regulations and would, if implemented, facilitate the expansion of securitisation as a far more effective credit risk and capital management tool for banks across the EU. Although the proposals involve relatively minor amendments to the existing regulations, their positive impact would be very significant.

More specifically, we make the following observations.

Recommendation 5a. Unlocking the Significant Risk Transfer Assessment process

- **Ranking**: Very important (5)

The "first loss" test

The first proposal here corrects what is widely seen as an error or anomaly in the current drafting of Articles 244(2) and 245(2) of the EU Capital Requirements Regulation ("**CRR**"), which prevents the use of the "first loss" test where the originator does retain a small first loss but there are no mezzanine tranches in the securitisation. This anomaly arises from the fact that the CRR defines mezzanine tranches as those tranches having a risk weight lower than 1250% and higher than 25%. However, in its current form, the first lost test requires that the originator does not hold more than 20% of *the* first loss tranche. Thus, where the tranches placed with investors have a risk weight of 1250% (which would be the case where the tranche attachment point is lower than K(IRB) or K(SA) (as applicable), but the bank has retained a small first loss tranche it would not be possible apply the first loss test. The proposal corrects this anomaly by providing that all tranches having a risk weight of 1250% (or which are subject to a deduction from CET1, which has a similar effect for this purpose) should effectively be treated together for the purpose of determining the proportion of those tranches which must be transferred to satisfy the first loss test. As this is largely correcting an anomaly, we welcome this change, which we do not think should be seen as controversial when properly understood.

In addition, the inclusion of the requirement for the size of the placed tranches to be at least equal to the sum of the lifetime expected losses and two thirds of the lifetime unexpected losses on the portfolio provides a more objective and workable alternative to the commensurate risk transfer test (as discussed further below).

Conclusion: We support the HLF proposal without any amendment.

Commensurate risk transfer

One of the most challenging aspects of the existing framework for significant risk transfer is the commensurate risk transfer test set out in Articles 244(2) and 245(2) of the CRR. It is not only originators who find this test difficult to apply in practice. As has been evident from the at times lengthy discussions between originators and their supervisors on specific transactions, as well as the ongoing work which the EBA has been undertaking to provide additional guidance around how this test is to be applied, **it has proven very difficult to come up with clear formulations** which work effectively across different types of securitisations and which do not produce anomalies from time to time. For example, in the case of the proposals set out in the EBA's Discussion Paper on Significant Risk Transfer in 2017, the industry has noted that there are various scenarios where SRT test would not be satisfied, despite their being other scenarios involving *less* risk transfer but which would satisfy the test. In light of this uncertainty, market experience has often been that this test is applied in an inconsistent and at times arbitrary manner by different supervisors, which creates great uncertainty for originators in their capital planning.

We therefore welcome the proposed deletion of this test from requirements in Articles 244(2) and 245(2) of the CRR, which we think will greatly simplify the process of achieving significant risk transfer.

Importantly, we do not think that the removal of this test will result in riskier transactions meeting the requirements for significant risk transfer, or that they will involve less effective risk transfer on the part of originators due to the stringent requirements which must be satisfied in order for the mechanistic tests to be satisfied. In this regard we note in particular the proposed inclusion in the first loss test of a requirement that the aggregate notional amount of the retained first loss and contiguous placed tranches must be at least equal to the sum of the lifetime expected losses and two thirds of the lifetime unexpected losses on the portfolio. This effectively prevents an originator from exploiting a loophole in the existing first loss test where it would technically be possible to satisfy the first loss tranche by selling a first loss tranche which exceeds the reasoned estimate of the expected losses, but without necessarily adequately covering the unexpected losses. Currently, the only way this loophole can be policed is through the commensurate risk transfer test. However, once this loophole is closed, **there is no longer the same need for the commensurate risk transfer to prevent such a transaction from achieving significant risk transfer**.

It is also worth noting that neither the mechanistic tests *nor* the commensurate risk transfer test for significant risk transfer form part of the Basel Accord, so the European regulations are currently more onerous in this regard than those that apply in other jurisdictions.

We also note that **the HLF recommended that ex-ante assessment of significant risk transfer transactions should only be required in the case of complex transactions**, to the extent that they include structuring features that diverge from generally accepted market standards and/or regulatory quantitative and qualitative criteria in the Level 1 text (see pages 51-2 of the report). This does not appear to be reflected in the actual proposals set out on page 61. We understand that this in on the basis that if the commensurate risk transfer test is removed, whether or not a transaction satisfies the requirements will become a quantitative question only, in which case originators will be able to determine whether or not they have satisfied the requirements to achieve significant risk transfer without needing to seek confirmation from their supervisor.

More generally, we note that the EBA is currently in the process of its review of the requirements for significant risk transfer, including a round table discussion to be held on 8 July 2020. We have a number of comments on how the SRT regime could be revised to make it work more effectively. However, we think it would be better to wait until after the EBA has published its views to go into those points in detail.

Conclusion: We agree with the proposed deletion of the commensurate risk transfer test from Articles 244(2) and 245(2) of the CRR.

Article 249

We do not follow the proposal in relation to Article 249(4) of the CRR, where we cannot actually identify any changes other the insertion of the word "either" at the end of the introductory clause which appears to be an error.

However, we think that an important change which should be made to Article 249 of the CRR is the **deletion of Article 249(3)** which currently imposes additional minimum rating requirements on the sellers of unfunded credit protection in a synthetic securitisation over and above those which apply under the credit risk mitigation framework in Part Three, Title II, Chapter 4 of the CRR. Not only is the minimum rating requirement here one notch lower than that which applies under the credit risk mitigation framework, but there is no carve-out for zero-risk-weighted counterparties (such as central governments and multilateral development banks). This means that an originator incorporated in a member state where the sovereign credit rating is below credit quality 3 (which corresponds to "AA") would not be able to execute a synthetic securitisation where the protection is provided by its own central government, even though it would be permitted to recognise untranched protection from its central government and accord a zero risk-weighting to the protected exposures in that case. **This limitation may have significant implications for the ability of national governments in a number of EU members states to provide relevant support to financial institutions in in their country in order to assist them to continue providing much-needed financing to the real economy during and following the Covid-19 pandemic**.

In the case of central governments, given that the CRR otherwise prescribes a zero-risk-weight for the central governments of all EU member states, and that financial institutions may therefore hold unlimited inventories of debt issued by such governments, it is an anomaly that such governments could be restricted from providing credit protection by way of synthetic securitisations, which by its very nature involves less exposure for the originator than holding a bond issued by that very same government.

In light of this, we do not think there is any legitimate reason for applying this additional requirement given that the CRR already requires the originator to risk-weight the protected tranche by reference to the risk-weight of the protection seller, and propose that this provision be deleted.

Conclusion: We propose to delete article 249(3) in the revised CRR.

Recommendation 5b. Recalibrating capital charges applied to senior tranches

- **Ranking**: Very important (5)

Risk weights

We strongly support recalibrating the capital charges which apply to securitisation tranches. The current risk weights, which stem from changes made to the Basel Accord following the global financial crisis of 2008-09, are widely viewed by the industry as unduly punitive, and based largely on the experience of sub-prime securitisation in the United States rather than on the experience in Europe, where default rates for securitisation were extremely low, and virtually non-existent on the senior tranches.

This strong performance of securitisation in Europe has recently been highlighted by the EBA in its Report on a STS framework for synthetic securitisation in the EU (May 2020). Against this backdrop, **the proposed recalibration of the risk-weights for securitisation tranches, including reducing the risk-weight floor to 7% for the originator, is most welcome and is likely to be very effective at stimulating the use of securitisation to stimulate lending across Europe**. Again, given the lived experience of virtually no defaults affecting the senior tranches which would be most affected by this recalibration, these changes would not undermine the capital position of originator banks.

Conclusion: We support the HLF proposal without any amendment.

Weighted Average Maturity

We note the reference in the HLF Report to the need for the EBA Guidelines for determining the weighted average maturity ("**WAM**") of a tranche to be amended to reflect the prevalent and well-established practices in the calculation of maturity of a securitisation tranche. This observation by the HLF may now have been superseded, as the EBA published its final report in on May 6, 2020. While this the final report improved on a number of imperfections in the draft Guidelines, a number of issues remain stemming, we understand, from constraints which the EBA felt were imposed by the primary text.

In particular, when calculating the WAM, **institutions should be permitted to take into account expected prepayment rates**, which is in-line with how tranche maturity is generally calculated by economic market participants.

Conclusion: We propose the following amendment to the HLF proposal:

- When calculating the WAM, banks are permitted to take into account expected prepayment rates

Recommendation 5c. Recalibrating capital treatment for securitisation positions under Solvency II

- **Ranking**: Very important (5)

We agree with the recommendation that the capital charges for securitisation positions under Solvency II need to be recalibrated. We understand that further analysis is required on the best way to achieve this, and **we would be very happy to provide any assistance which would be useful to assist with that analysis**.

Conclusion: We agree with the HLF proposal to review Solvency II capital charges for STS securitisations and would be very happy to provide any assistance which would be useful to assist with that analysis.

Recommendation 5d. Reducing the costs of SME financing

- **Ranking**: Average importance (3)

Conclusion: We support the HLF proposal without any amendment.

Recommendation 5e. Applying equivalent treatment to cash and synthetic securitisation for all asset classes, including the application for STS

- **Ranking**: Very important (5)

We strongly support the proposal to align the treatment of traditional and synthetic securitisation. In this regard, we also note the recent EBA report on the establishment of a STS framework for synthetic securitisation which was published on May 6, 2020.

The HLF Report proposes to remove some of the restrictions in Article 270 of the CRR, the effect of which would be to allow the originator to apply the STS risk-weight to the senior tranche of a synthetic securitisation which satisfies the criteria for STS securitisation other than the requirement for a true sale. In this regard, the proposal goes further than the EBA proposals, which propose a separate set of STS criteria for synthetic securitisation which would need to be complied with in order for the STS risk-weights to be applied. The EBA criteria are better suited to synthetic securitisation than the existing STS criteria which have been drafted with traditional securitisation in mind. Generally, therefore, we would suggest extending STS treatment to synthetic securitisation through adoption of the EBA proposals rather than by simple modification of Article 270 as proposed by the HLF. Given the detailed work which the EBA has done on this topic, we think that this could also be implemented relatively quickly.

That said, in one important regard, **the EBA proposals are more restrictive than those proposed by the HLF**, in that they prevent the use of unfunded protection for a synthetic STS securitisation where the protection seller is not a government or multilateral development bank. We do not think that this limitation is necessary given that, as noted above in relation to Article 249(3) of the CRR, the originator would in those circumstances be required to take into account the risk-weight of the protection seller in its capital calculations.

One observation which applies equally to both the HLF proposals and the EBA proposals is that the STS risk-weight would apply only to the most senior tranche in the securitisation where that is retained by the originator. We do not think there are any concerns with limiting this treatment to tranches retained by the originator, as it is universally the case that the originator does retain the senior tranches in a balance sheet synthetic securitisation.

We would, however, suggest a minor adjustment to the proposals so that, instead of the treatment being limited to the most senior retained tranche, it would also apply to *any* retained tranche which is contiguous with the most senior retained tranche. This will not make any difference where the originator applies the SEC-IRBA or SEC-SA methodologies, as in those cases you would only ever expect to have one retained senior tranche, which would represent all of the portfolio above the tranche(s) placed with investors. However, for a standardised portfolio, it will make a difference, because in order to optimise the rating on the most senior tranche, it is usually necessary to divide the retained position into a number of sub-tranches. Where these separate tranches are all retained by the originator, it would therefore be consistent with the SEC-IRBA or SEC-SA outcomes for the STS risk-weights to apply to all of those retained tranches.

While IRB Banks do sometimes execute balance sheet synthetic securitisations in relation to standardised portfolios, **this is particularly an issue for Standardised Banks**, which are not able to use the SEC-IRBA methodology, and is important to ensuring a level playing field for banks across the EU.

Please also see attached a slide prepared by Santander which illustrates this point further.

Conclusion: We suggest:

- extending STS treatment to synthetic securitisation through adoption of the EBA proposals rather than by simple modification of Article 270 as proposed by the HLF
- removing the limitation on the use of unfunded protection for a synthetic STS securitisation where the protection seller is not a government or multilateral development bank
- removing the limitation, in both EBA and HLF proposals, that the STS risk-weight would apply only to the most senior tranche in the securitisation where that is retained by the originator. Instead of the treatment being limited to the most senior retained tranche, it would also apply to *any* retained tranche which is contiguous with the most senior retained tranche.

Recommendation 5f. Upgrading eligibility of senior STS and non-STS tranches in the LCR ratio

- **Ranking**: Very important (5)

Upgrading HQLA-Level eligibility in LCR ratio is very important for large senior tranches of senior securitizations, to increase diversity in banks HQLA portfolios as well as price stability on these large AAA assets, by increasing market flows. We however agree maintaining current eligibility for HQLA Level 2B for senior securitization tranches that do not meet the higher requirements for upper HQLA level.

Conclusion: We support the HLF proposal without any amendment.

Recommendation 5g. Differentiating between disclosure and the due diligence requirements for public and private securitisation

- **Ranking**: Very important (5)

Application of disclosure templates

When the draft reporting technical standards (the "**RTS**") for the EU Securitisation Regulation were prepared by ESMA, and throughout the public consultation process, it was always understood that the prescribed reporting templates set out in those RTS would only apply to public securitisations, being securitisations for which a prospectus is required to be drawn up under the EU Prospectus Directive. While the general obligation to disclose loan-level data and provide other information under Article 7(1) of the EU Securitisation Regulation would still apply to private securitisations, it would be up to the parties to determine what level of disclosure was sufficient to satisfy those obligations. This would include most of the synthetic securitisation market, which these days tends to be on the private side.

However, as is now well-known, when ESMA published the final RTS, this position was changed so that both public and private securitisations would be required to report using the reporting templates. Although these rules have not yet taken effect (they are expected to do so imminently), they have caused significant consternation across the securitisation industry.

While the reporting templates are relatively unproblematic for traditional securitisations of the "traditional" asset classes, such as RMBS and auto loans, they are very problematic for other types of exposures. In particular, it is very difficult for originators to comply with these templates in the case of larger exposures, where the level of information being disclosed makes it difficult to avoid breaching confidentiality obligations and regulatory requirements in relation to the disclosure of inside information.

We want to stress that this is *not* a case of banks wanting to avoid disclosure in these transactions. On the contrary, because investors usually invest in the first loss or lower mezzanine tranche in a balance sheet synthetic securitisation, it has always been the case that they receive very detailed data about the underlying exposures, both before closing and over the life of the transaction.

What is proving very difficult at the moment is the requirement to comply with the "one size fits all" templates which have clearly been produced with traditional securitisation in mind, and which are ill-suited to synthetic securitisations. We would also add that in *no* case to date have investors viewed this mandatory disclosure as a substitute for their traditional, detailed disclosure requirements, which continue to be required across the board.

We therefore strongly support the HLF proposals to revert to the position anticipated from the original draft RTS, and leave it up to the parties to decide how and what is required to be reported in a private securitisation.

Conclusion: We strongly support the HLF proposal without any amendment.

Third-country securitisation

There is currently an ambiguity in the EU Securitisation Regulation as to whether or not a non-EU originator is required to apply the ESMA disclosure templates to a non-EU securitisation which is being marketed to EU investors.

Compliance with these disclosure templates is also difficult for non-EU originators in many cases because they have been largely been prepared with European assets in mind, and therefore do not apply well to non-EU exposures. We therefore agree with the HLF's proposals that when investing in a non-EU securitisation, it should be clarified that it is up to the investors to determine what level of disclosure is sufficient for them to satisfy their due diligence obligations.

We note, however, that **the current proposal refers to the originator, sponsor or SSPE needs to ensure that EU investors have sufficient information** to conduct their due diligence. Given that the EU Securitisation Regulation does not actually apply to a non-EU originator (as it is not subject to EU law), this provision should instead require that the EU investor is satisfied that the level of disclosure which is made by the originator, sponsor or SSPE is sufficient to enable the investor to comply with its due diligence obligations.

Conclusion: We propose amending the HLF proposal by referring to the needs that "*EU investors are satisfied that the level of disclosure, which is made by the originator, sponsor or SSPE is sufficient to enable them to comply with their due diligence obligations.*"

Securitisation of legacy and NPE pools

Another of the known problems with the EU Securitisation Regulation is the requirement that where an originator purchases a third party's exposures for the purposes of securitising them, it must verify that the exposures were originated in accordance with sound and well-defined criteria for credit-granting. This presents a particular problem in the context of the securitisation of non-performing exposures, where either the origination may not in fact have complied with such standards or the original lender may no longer be in existence or co-operative to enable the originator to conduct such a verification. This effectively acts as a bar on undertaking a securitisation of these exposures, even though the investors would be well-aware that they are investing in a much riskier transaction.

We therefore support the HLF proposal to require instead that the originator conducts due diligence in relation to the origination standards and then discloses the findings of that due diligence to investors.

Conclusion: We support the HLF proposal without any amendment.

ATTACHMENT

STS for Synthetics – Senior Contiguous Tranches

- Differentiated STS capital treatment should be **extended to non-senior tranches** where a) retained by the originator and b) are contiguous with the retained senior tranche
- SEC-ERBA – Have to divide into more tranches to meet Rating Agency requirements; **risk to the originator remains unchanged**
- Will help to provide a more **level playing field** for IRB and Standardised banks
- Note that in the example provided, the capital relief for the suggested approach when using SEC-ERBA still remains **c.20% below** the SEC-IRBA approach

1 SEC-IRBA

Illustrative Example (EUR 1bn)

Retention (5%)

TRANCHE	NON-STS	STS
Senior EUR 890m (Retained)	15%	10%
Mezzanine EUR 100m (Placed)	0%	0%
First Loss EUR 10m (Retained)	1250%	1250%
CAPITAL CHARGE: 80	21	17
CAPITAL SAVINGS:	59	63
CAPITAL SAVINGS (%):	74%	79%
ADDITIONAL STS CAPITAL SAVINGS:		6.00%

K_{IRB}

2 SEC-ERBA

STS Preferential Capital Treatment for Senior Tranche Only

Retention (5%)

TRANCHE	NON-STS	STS
AAA EUR 790m (Retained)	20%	10%
AA EUR 50m (Retained)	120%	120%
BBB EUR 50m (Retained)	310%	310%
BB EUR 50m (Placed)	760%	760%
NR EUR 50m (Placed)	1250%	1250%
NR EUR 10m (Retained)	1250%	1250%
CAPITAL CHARGE: 80	40	34
CAPITAL SAVINGS:	40	46
CAPITAL SAVINGS (%):	50%	58%
ADDITIONAL STS CAPITAL SAVINGS:		15.74%

K_{SA}

3 SEC-ERBA

STS Preferential Capital Treatment for Senior Contiguous Tranches

Retention (5%)

TRANCHE	NON-STS	STS
AAA EUR 790m (Retained)	20%	10%
AA EUR 50m (Retained)	120%	70%
BBB EUR 50m (Retained)	310%	255%
BB EUR 50m (Placed)	760%	655%
NR EUR 50m (Placed)	1250%	1250%
NR EUR 10m (Retained)	1250%	1250%
CAPITAL CHARGE: 80	40	29
CAPITAL SAVINGS:	40	51
CAPITAL SAVINGS (%):	50%	63%
ADDITIONAL STS CAPITAL SAVINGS:		26.20%

K_{SA}

[1] Assumptions: 1) Underlying assets have a RW of 100%; 2) Bank has a target CET1 ratio of 8%; 3) SEC-ERBA - For simplicity, assumed that each tranche has a M_T of 5 years; 4) SEC-ERBA - Ratings mappings based on S&P, using guidance in EBA Q&A 2018_4274.

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