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IACPM

IACPM Response to PRA Discussion Paper DP3/23
Securitisation: Capital Requirements

Introduction

IACPM is pleased to respond to the PRA's Discussion Paper DP3/23 (the "**Discussion Paper**") in connection with potential amendments to certain aspects of the securitisation capital framework currently set out in Part Three, Title II, Chapter 5 of the UK Capital Requirements Regulation (the "**CRR**").

Our response focusses on the impact which these proposals would have on **synthetic securitisations** executed by banks for the purposes of achieving significant risk transfer. We have not sought to comment on the impact of the rules on other types of securitisations and refer therefore to the response that will be provided to the PRA by the AFME.

We would welcome the opportunity to discuss our response with the PRA.

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General Observations on the Output Floor and Securitisation

The Impact of the p-factor under the Output Floor

As we observed in our response to the PRA's Consultation Paper on the Basel 3.1 Standards (CP16/22),[1] the application of the output floor under Basel 3.1 is particularly problematic in the context of significant risk transfer ("**SRT**") securitisations. This is due to the fact that a securitisation structured under the SEC-IRBA methodology will generally require significantly thinner tranches to be transferred to investors than a securitisation of the same portfolio structured under the SEC-SA methodology. Accordingly, in order to provide appropriate capital relief, when that securitisation is risk-weighted under the SEC-SA for output floor purposes, the overall post-securitisation risk-weight of the securitised portfolio for the originator (including taking into account the 1250% risk-weight that applies to any retained first loss tranche) will generally be greater than 80% (or greater than 60% once the 72.5% multiplier that applies under the output floor is taken into account), as shown in the examples in Appendix A). This compares with an overall post-securitisation risk-weight of between 15% to 27% under the SEC-IRBA.[2] Given that the cost of the transaction for the originator will be the

[1] IACPM Response to PRA Consultation Paper on Basel 3.1 Standards: IACPM Basel 3.1 Response Letter

[2] References in this response to the post-securitisation risk-weight are to the effective risk-weight of the entire securitised portfolio from the originator's perspective, calculated by reference to the total risk-weighted amounts against which the originator is required to hold own funds in respect of each retained tranche in the resulting securitisation.

same as under the SEC-IRBA, this also means that the effective cost of generating that much smaller amount of capital relief will be significantly higher than the institution's cost of capital, meaning the transaction is unlikely to be economically viable. Optimising the structure for the SEC-SA would mean increasing the thickness of the tranches transferred to investors. However, this increases the cost of the transaction materially as can be seen in the examples in Appendix A. With a p-factor of 1, the application of the output floor means the cost of the capital relief is many multiples of that which applies under the SEC-SA (from around 360% at the low end, to in excess of 10,000% at the upper end). Even with a p-factor of 0.5, the cost of that capital relief remains between around 150% to 230% of that which applies under the SEC-IRBA.

Thus, once an institution is constrained by the output floor, the impact of the floor is of a different nature for securitisations compared with its impact on unsecuritised exposures. For unsecuritised exposures, the institution simply replaces the risk-weight of the exposure with the standardised risk-weight, and then calculates the RWA of the exposure for output floor purposes based on 72.5% of that standardised risk-weight. However, in the case of a securitisation, the output floor effectively has two separate impacts; it both increases the risk-weight applied to the securitised exposures which is an input into the securitisation risk-weight (ie, moving from K_{IRB} to K_{SA}), and then largely nullifies the effect of securitisation because of the higher retained senior tranche attachment point required to achieve a viable risk-weight under the SEC-SA methodology. This will ultimately lead to SRT securitisation no longer being a viable capital and credit risk management tool for UK banks, putting them at a competitive disadvantage to their EU peers, as well as increasing the risk retained in the UK banking sector.

IACPM members do not believe that this was an intentional outcome of the output floor, but rather is an unintended by-product of the way in which it is set out in the Basel framework. It is therefore necessary to consider whether there are ways of mitigating that unintentional outcome so that the output floor can apply to securitisations in a way which is more consistent with the impact which it has on unsecuritised exposures. This is where the p-factor comes into play because it represents a parameter in the SEC-SA formula which can be adjusted in a way which counterbalances the effect of the output floor without requiring significant changes to the rest of the securitisation framework (as has been done in other jurisdictions such as the EU).

As the PRA notes, the p-factor is a "non-neutrality" factor, which works to apply a capital surcharge on securitisation positions. When the p-factor is set at 1, as is currently the case under the SEC-SA, the effect is essentially that the sum of the RWAs of all the tranches in the securitisation is increased by approximately 100% over the sum of the RWAs that would apply to those exposures on an unsecuritised basis (or even more than 100% once the effect of the 15% risk-weight floor is taken into account). If the p-factor is set at 0.5, this surcharge would be approximately 50%, while if the p-factor is set at 0.25, the surcharge would be approximately 25%, and so forth. The p-factor applies under both the SEC-IRBA and the SEC-SA, although under the current framework, the SEC-IRBA p-factor is determined by a formula which will usually generate a lower value than applies under the SEC-SA (subject to a floor at 0.3).

The SEC-SA will almost always produce a higher risk-weight for a given tranche of a securitisation than the SEC-IRBA. This is primarily due to two factors. First, the p-factor under the SEC-SA is always 1,[3] whereas under the SEC-IRBA, it will usually be significantly lower than 1. Secondly, the SEC-SA uses K_A, based on K_{SA}, as the unsecuritised capital charge for the securitised portfolio, rather than the K_{IRB} capital charge which is used in the SEC-IRBA. While not universally the case, K_{IRB} is generally significantly lower than K_{SA} for a given portfolio. Thus, not only is the p-factor generally higher under the SEC-SA, but that higher multiplier is being applied to a higher base capital charge to start with, thus compounding the effect.

While replacing K_{IRB} with K_A in the securitisation formula is consistent with the underlying principle of the output floor, there is no reason why it necessarily follows that a higher p-factor should also apply. This has nothing to do with the difference between the risk-weight which applies to a given exposure under the IRB Approach and that which applies under the Standardised Approach. Rather the purpose of p-factor is to address regulatory concerns that the complexity of a securitisation adds additional risk, and therefore requires holding additional capital. However, because the SEC-IRBA formula and the SEC-SA formula are the same[4], given that K_A is almost always higher than K_{IRB} in the first place, even with an identical p-factor, the amount of the capital surcharge generated by the p-factor will also be higher under the SEC-SA than under the SEC-IRBA. There is no reason to amplify the additional conservatism built into K_A by also imposing a higher p-factor. Indeed, because of that conservatism, the capital surcharge (in absolute terms) will actually be higher under the SEC-SA even with a p-factor that is *lower* than that which applies under the SEC-IRBA. Even if it is accepted that securitisation adds risk (although IACPM members disagree with that assertion), given the SEC-SA is starting from a more conservative starting base in K_A rather than K_{IRB}, there is no reason why the absolute amount of that capital surcharge needs to be *higher* under the SEC-SA than it is under the SEC-IRBA. However, this also means that reducing the p-factor in the SEC-SA formula would help to offset the impact of the output floor by reducing the extent to which the SEC-SA risk-weight for a given tranche in a securitisation would be higher than the SEC-IRBA risk-weight for the corresponding tranche.

As we also mentioned in our response to PRA CP16/22, it is important to consider the impact of the output floor on a transaction-by-transaction basis. Although the output floor itself technically only applies at UK group level, within a bank, the impact of the output floor will need to be allocated to the relevant business units. This means that, once a bank is constrained by the output floor, transactions will effectively be assessed based on their contribution to the output floor capital requirements. Further, whether or not an institution is constrained by the output floor can depend on factors that have nothing to do with a given portfolio or transaction. For example, the sale of a portfolio which is capitalised under the Standardised Approach may itself be sufficient to cause an IRB bank to become subject to the floor even if there is no change to its IRB assets. Therefore, a bank needs to be able to assess the capital consumption of each part of its business, and ultimately each transaction, on a standalone basis in order to ensure the viability of that part of the business over the term of

[3] The p-factor will be 0.5 for STS securitisations but given there are very few traditional securitisations which achieve SRT in the UK, the focus of this response is on the much more significant *synthetic* SRT securitisations, for which there is no STS regime in the UK.

[4] The only differences between the two formulae are the inputs K_{IRB}/K_A and p.

the transaction on the assumption that the output floor will apply, even if that is not initially the case.

Before turning to the specific options considered by the PRA in the Discussion Paper, some preliminary remarks about securitisation are warranted.

The Benefits of SRT Securitisation

First, the effect of SRT securitisation is to transfer risk from the originator to the investors. In the UK, as is also the case in the EU, these investors are always non-bank institutions. Thus, SRT securitisation contributes to the safety and soundness of the UK banking sector by reducing the risk that credit losses will be incurred by banks. It is important that this benefit is taken into account when considering the appropriate regulatory treatment of SRT securitisations, and that that regulatory treatment does not focus solely on the fact that a SRT securitisation also allows the bank to reduce its regulatory capital requirements. Ultimately, the bank is only permitted to reduce its regulatory capital requirement because it *has* also transferred the risk to investors.

Achieving SRT requires the originator to adhere to strict requirements set out in the CRR and is subject to the assessment regime by the PRA, whereby the PRA is empowered to disallow the recognition of any capital benefit where the securitisation does not meet those requirements, including the subjective requirement to demonstrate that there has been a commensurate transfer of risk. The PRA is widely recognised in the market as performing the most rigorous assessments of SRT securitisations, and the result is that there can be a high degree of confidence that those SRT securitisations which are executed do in fact meet all the requirements for an effective transfer of risk.

Further, because of the non-neutrality in the securitisation framework, resulting from *both* the p-factor and the 15% risk-weight floor which applies to the retained senior tranche, securitisation actually *increases* the amount of economic capital held against the securitised exposures compared with the own funds requirement which the originator would otherwise be holding against those exposures. In fact, the non-neutrality factors actually understate that increase in economic terms in the case of a funded SRT securitisation because the originator will be holding collateral (invariably cash or government securities) having a nominal value equal to the size of the protected tranches and which it is permitted to apply against losses on the securitised portfolio. This is equivalent to holding capital on a full deduction basis for those protected tranches. While it is true that the terms of that capital are different from common equity or Tier 1 capital, it remains available to absorb losses on the securitised exposures in the same way as common equity. The availability of this loss-absorbing economic capital needs to be recognised when considering the appropriate regulatory capital requirements for the retained tranches in a SRT securitisation.

SRT securitisation markets have now been functioning effectively in the UK and EU for more than a dozen years without any indication that they have failed in their purpose of absorbing losses on the securitised exposures. Indeed, over that time period, there have been numerous losses covered by such securitisations, with no evidence of the protection not functioning in the way it was intended to do or as envisaged by the regulatory framework. During that time,

markets have weathered significant shocks, such as the COVID pandemic and rises in interest rates and inflation. There are *no* recorded examples where the senior retained tranches of a SRT securitisation executed in the UK or EU have borne losses, or even come close to doing so, given the conservative tranching enforced by both the SEC-IRBA and SEC-SA formulae.[5] The reality is, SRT securitisations function in exactly the way they are meant to, and really do transfer risk away from the banking sector. This is a positive contribution to the safety and stability of the banking system, and rather than being viewed with suspicion or as something to be discouraged, SRT securitisation should instead be viewed as an important part of proper credit risk and capital management by banks. The prudential treatment of securitisation should reflect that.

Distinction between Originator and Investors

One of the challenges with the existing securitisation framework is that it largely applies in the same way to both originators and investors in a securitisation. One of the common concerns expressed by regulators (such as in Paragraph 2.17 of the Discussion Paper) is that different participants in a securitisation often have access to varying levels of information, and this often results in the regulations applying a more conservative approach to the treatment of securitisation positions. However, it is here that the distinction between the position of an originator and the position of investors is important. By definition, the originator has access to the same information about the securitised exposures whether or not they are securitised. Accordingly, a lack of information should not be a factor justifying any non-neutrality factors for the originator. IACPM members urge the PRA to bear this in mind when considering the issues raised in the Discussion Paper. It may in fact be appropriate to distinguish between the position of the originator and investors in some places. For example, even if the PRA is minded to retain the p-factor of 1 for investors, that should not prevent allowing the originator of the securitisation to apply a lower p-factor to the retained tranches.

Availability of Information

As always, we remain happy to assist in providing any further information that the PRA may consider necessary or useful as it considers the matters raised in the Discussion Paper.

The Need for Revision or Recalibration of the Securitisation Framework

We note that, in Paragraph 2.19 of the Discussion Paper, the PRA indicates that it is open to re-evaluation of the securitisation capital framework, and in particular the non-neutrality factors, by the BCBS. IACPM members agree that such a revision or recalibration is necessary but disagree that this can only be done through the BCBS given the well-documented deficiencies with the existing framework. The last time the securitisation framework was revised, following the Global Financial Crisis, the result was a framework that was largely calibrated based on the experience with US sub-prime mortgage securitisation and which completely failed to take into account the observed performance of securitisation in the UK

[5] Various structural features of SRT securitisations also reduce the risk of losses being borne by the senior tranche. For example, where pro-rata amortisation is used, triggers are always included to switch to sequential amortisation where the performance of the securitised exposures indicates that there is an increased risk of losses being greater than anticipated when the transaction was executed.

and EU, even throughout the GFC. The benefits of securitisation were largely ignored, and in the UK and EU securitisations were subject to a much more onerous capital regime even though there was no evidence that the existing capital regime had failed adequately to capitalise the risk associated with those securitisations. This is not to say that there were not problems with how securitisation markets functioned in the UK and EU in the lead-up to the GFC, but rather that the very significant increases in the risk-weights for senior securitisation positions (including the increase in the risk-weight floor from 7% to 15%), and the switch from the SSFA to the SEC-IRBA, were not the way to address those issues. Rather, those issues have since been very effectively addressed by the non-capital reforms to securitisation through the EU, and now, UK Securitisation Regulations, such as risk retention, disclosure and reporting, due diligence obligations for investors, the imposition of minimum origination standards and the ban on resecuritisation. Ironically, the effect of the more onerous requirements has been to reduce very significantly the levels of securitisation in the EU and UK compared with the US (where the capital reforms were not implemented in any case).

While IACPM members agree that there are benefits to global standards, particularly given the global nature of banking and financial markets, there are also important differences between different markets, and it is important to take those differences into account by making appropriate amendments to those global standards where necessary. We therefore urge the PRA to consider ways in which the securitisation capital framework could be improved for the UK market, without necessarily waiting for a full review at the level of the BCBS. The proposals being considered in the Discussion Paper are examples of tweaks that could be made which would improve the framework as it applies in the UK.

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Responses to Specific Questions raised in the Discussion Paper

Q1: *To what extent do firms expect to be able to mitigate the potential impact of the output floor on securitisation exposures, including retained tranches of SRT securitisations? Please provide estimates of costs and benefits and / or illustrative examples.*

As shown in the examples set out in Appendix A, the impact of the output floor on most SEC-IRBA securitisations with a SEC-SA p-factor of 1.0 is to increase the effective risk-weight of the securitised portfolio to in excess of 60%, and an increase in the cost of the capital released by between 360% to in excess of 10,000%. This is *after* taking into account the fact that the output floor applies a 72.5% multiplier to the starting risk-weight generated by the SEC-SA, and therefore by implication reduces the effective risk-weight of any retained first loss tranche. Looking just at the impact on the senior tranche risk-weight, the examples in Appendix B show that risk-weight increasing from the current 15% to in excess of 70% (again, after applying the 72.5% multiplier to this SEC-SA risk-weight). Even with a senior tranche attachment point of 15%, significantly higher than would be the case for most SEC-IRBA securitisations, the output floor SEC-SA risk-weight remains around 36%. Depending on the starting point, this results in an overall portfolio risk-weight which is between two and three *times* the SEC-IRBA risk-weight for that portfolio, thereby reducing the capital saving accordingly *without any corresponding reduction in the cost of the securitisation*. This raises

concerns around the high cost of credit protection (HCCP), as the cost of the capital relief generated by the securitisation will have increased two or three-fold once the output floor is taken into account.

These increases also clearly demonstrate the overconservative nature of the SEC-SA formula. Even if the PRA's own suggested calibration was applied, and the placed tranche has a thickness of 1.5 times K_{SA} was applied, the resulting risk-weight for the securitised portfolio would still be in excess of 65% (after applying the 72.5% multiplier), which is clearly far too high for the actual level of risk implied which is reflected in the retained tranches.

Without a change to the p-factor, there is simply no cost-effective way for banks to mitigate the impact of the output floor on securitisations which apply the SEC-IRBA methodology. The only way to mitigate the effect is for the bank to place significantly thicker and/or additional mezzanine tranches of the securitisation with investors, over and above that which is necessary to achieve SRT under the SEC-IRBA. However, as shown in Appendix A, in order for the retained senior tranche to achieve the 15% risk-weight floor under the SEC-SA, the thickness of the placed tranche(s) would need to increase to almost 300% of the thickness required to achieve a 15% risk-weight floor under the SEC-IRBA. This naturally comes with a cost.

From an economic perspective, there is little if any additional real risk being transferred through the thicker tranches. Given that the SEC-IRBA securitisation will have been tranched on the basis that there is no expectation of losses being borne by the senior tranche, even in stress cases, transferring part of that senior tranche does not really involve any additional transfer of risk over and above that which is already achieved by the SEC-IRBA tranching. This creates a quandary for the bank, because it derives no credit risk or economic benefit from the thicker tranches. The only benefit will be the ability to apply the risk-weight floor to the residual retained senior tranche under the SEC-SA for the purposes of the output floor.

While from an economic perspective the additional placed tranche is essentially risk-free, investors will still expect a return for providing that protection. This is particularly the case for funded credit protection, where the investor is required to lock up its capital for the duration of the securitisation, and IACPM members do not consider that the existing funded investor base for SRT securitisations would be willing to purchase these tranches at an economic price. Of course, it is possible to separate the tranche required for SEC-IRBA purposes from an additional mezzanine tranche required for SEC-SA purposes, with different investors participating in each tranche. However, this will require banks to find a different investor base for such senior mezzanine tranches. As there is currently little or no market for such unrated and funded mezzanine risk and there is no logical investor base for such risk, it cannot be assumed that this will be possible.

One possible investor base for these senior mezzanine tranches would be the insurance sector, which may be willing to provide such protection for some types of portfolios on an unfunded basis. In this regard, we note the discussion in Chapter 5 of the Discussion Paper and our responses to Questions 8–10 below. There have been a number of examples in recent years where banks have used unfunded mezzanine tranches to effect additional risk transfer for various reasons, although this remains a relatively small part of the overall SRT market, and

limited to only a few asset classes, so it remains to be seen how viable such protection would be from a cost perspective. Furthermore, given the size of the mezzanine risk in aggregate that would need to be placed to maintain the current market size, the impact would be that the banking sector would have oversized exposures to a small group of sophisticated insurance providers on an unfunded basis which would not necessarily be permissible depending on a bank's policies on counterparty exposure.

A second possible investor base for these mezzanine tranches would be non-SRT traditional ABS investors. However, this would bring its own challenges. As is often remarked, the SRT market has historically been largely a private market, which has benefited from the ability of originators and investors to engage in detailed negotiations over the specific terms of a transaction in a way which is not generally possible in public securitisations. Involving traditional ABS investors to purchase the additional mezzanine tranches would likely require changes to existing SRT structures (such as the allocation of control and voting rights) in ways which are likely to be unpalatable to the existing SRT investor base. In addition, many non-SRT ABS investors are likely to require ratings, which would add further cost and complexity to the process of executing a SRT securitisation and add additional unnecessary constraints on portfolios to adhere to methodologies applied by rating agencies. Furthermore, this may potentially have other implications depending on the approach which the PRA takes in relation to the hierarchy of methods discussed in Chapter 3 of the Discussion Paper (see further our response to Question 6, below in this regard). This is very much a case of letting the tail wag the dog, in the sense that it would result in the process of executing a SRT securitisation becoming much more time consuming and costly, not to achieve any real additional risk transfer, but simply to accommodate the unintended impact of the output floor on perfectly sound SEC-IRBA securitisations.

Even if an investor base could be found for these additional mezzanine tranches, the outcome is that the bank is paying considerably more for less overall capital relief, again raising concerns from a HCCP perspective.

Accordingly, these options do not represent an effective way of mitigating what is an artificial problem in the first place.

Grandfathering

Whatever the outcome on the p-factor, IACPM members urge the PRA to provide for grandfathering of existing securitisations from the output floor. This would be important to avoid any potential cliff edge impact where banks would be subject to a very significant increase in their capital requirements for securitisation positions upon the output floor coming into effect. Even the mitigation options referred to above would be difficult to apply to such existing securitisations, as it would require placing additional mezzanine tranches without any ability to modify the existing securitisation to reflect additional requirements of the investors in those additional mezzanine tranches.

While the phase-in period for the output floor does purport to mitigate this cliff edge impact to some extent, this relief is illusory in practice because banks will be required to report their full-loaded output floor capital requirements from the outset, meaning that transactions will

already be assessed taking the full impact of the output floor into account. In any case, the phase-in period also means by the time the output floor is fully implemented, there would be relatively few grandfathered securitisation positions remaining.

Such grandfathering could be achieved by the output floor rules allowing the IRB Approach and SEC-IRBA to continue to be applied to securitisations executed (or acquired) prior to the implementation of the output floor for the purposes of the bank's output floor calculations.

Grandfathering would be much less necessary if the PRA does ultimately decide to implement a lower p-factor for the SEC-SA in the way discussed in either Options 2 or 3 below.

Q2: *How do you consider that option 2 could be developed?*

For the reasons already set out above, IACPM members do not consider that Option 1 is a viable approach to the implementation of the output floor.

Before considering the specifics of how Option 2 could be implemented in the UK, however, we think it is useful to set out our views on the various policy considerations discussed in the Discussion Paper (ie, to respond to Question 5 from the Discussion Paper).

In response to the PRA's observations in Paragraph 2.24 of the Discussion Paper, it is obviously correct to say that Option 1 provides a higher level of safety than Options 2 or 3, in the sense that holding more capital is always safer than holding less capital. However, we challenge the premise of that assertion. To start with, it assumes that banks would continue to execute securitisations under Option 1, which is by no means certain. As set out above, given the very significant increase in the cost of such securitisations and/or the significant reduction in the benefit which the securitisation would have for the bank, the level of SRT securitisation activity would be significantly reduced. This should *not* be seen as a positive outcome for the safety and stability of the banking system because it also means that there would be less transfer of risk outside the banking system and an increase in the losses suffered by banks. Even if banks are adequately capitalised, incurring those loses would have an adverse impact on the financial position of the bank, including on its profit and loss performance and ability to replenish its capital base following such losses. This is before even considering the point discussed above, that post-securitisation, the bank actually has more resources available to absorb those losses than it had pre-securitisation.

Secondly, the goal of the prudential capital framework should not be to require all banks to hold so much capital that *no* bank can ever fail. Rather, the question is how to strike the right balance between safety on the one hand and efficiency and economic viability on the other. Or to put it another way, by determining what level of risk is appropriate for the market as a whole. In any financial system, there will inevitably be entities which experience financial difficulties (although we do note that securitisation in the UK has performed extremely well since the GFC and has not been the cause of any banks getting into financial trouble), and the recovery and resolution framework exists to deal with such situations. However, responsible

economic actors should not be penalised solely because of that risk. The parameters need to be set at the right level for the financial system as a whole.

Accordingly, IACPM members do not believe that the perception that Option 1 represents a safer or more prudent approach stands up to thorough scrutiny, and an unintended or outsized impact of the output floor cannot be justified solely on that basis.

IACPM members also strongly disagree with the suggestion in Paragraph 2.26 of the Discussion Paper that Option 1 could be seen as facilitating effective competition between IRB and SA banks. While it is true that SA banks tend not to originate SRT securitisations, a significant reason for this is the overly conservative nature of the p-factor in the SEC-SA formula (as shown by the examples in Appendix A). The contrast with the position in the EU is instructive here. Since the STS framework was extended to synthetic SRT securitisations in the EU in 2021, which reduced the p-factor for the originator under the SEC-SA formula to 0.5, there has been a significant increase in the use of synthetic SRT securitisation by SA banks in many EU jurisdictions. This has been seen by the regulators of those banks as significantly strengthening the capital position and financial resilience of those institutions. This is, in fact, a good example of how Option 2 could actually improve competitiveness for smaller UK banks, as it would make SRT securitisation far more viable as a risk management tool than it currently is.

Indeed, noting the PRA's comment in Paragraph 2.11 of the Discussion Paper that only six banks have thus far executed SRT in the UK, a simple deduction will inform that these six are all large, IRB banks (although in a number of cases those IRB banks have executed SRT transactions on standardised portfolios, where it has been possible to apply the SEC-ERBA). Lowering the p-factor for the SEC-SA will help to correct this imbalance and level the playing field, allowing smaller/challenger banks to gain access to this important credit risk and capital management tool.

Even if this were not the case, the output floor was not intended as a tool to increase the competitiveness of smaller banks by removing the advantage generated by the IRB approach, and it would be inappropriate to adopt Option 1 for that reason. The operation of the output floor must be justified on the basis that it addresses an identified shortcoming in the financial stability of IRB banks, not that it increases competitiveness between IRB and SA banks.

In response to the PRA's observations in Paragraph 2.27 of the Discussion Paper, while IACPM members do broadly support global standards, there is little benefit in adhering to global standards if no one else does. Of the two most significant global regulatory jurisdictions, the EU has clearly recognised that it is inappropriate to apply the output floor to securitisations in the manner envisaged by Option 1 and has instead opted for a version of Option 3. The other key jurisdiction, the US, is not a useful point of comparison, because it does not apply the SEC-IRBA anyway, and so all securitisations are affected under the SEC-SA (although until now, it has actually continued to apply the old SSFA with its effective p-factor of 0.5). Though it is currently proposing to implement the Basel 3.1 "Endgame" with a p-factor of 1, there is a very active lobbying effort underway in the US at present to have that reduced (which would essentially be similar to Option 2 being considered by the PRA). While the outcome of that is not yet known, it is entirely possible that both the EU and the US will end up with a

securitisation framework that applies a p-factor of less than 1 in the case of banks of the kind that would apply the IRB Approach in the UK. If that were to happen, but the PRA pursued Option 1 in the UK, that would leave UK banks at a very considerable economic disadvantage to their major competitors in both the EU and the US. To the point in Paragraph 2.49 of the Discussion Paper, it is also important to assess "global competitiveness" by reference to the *actual* rules applied to UK banks competitors, and not by reference to theoretical rules which are not (or may not be) actually applied to those competitors.

In our view and on that basis, Option 1 cannot be justified. The question then becomes whether to pursue Option 2 or Option 3. Given IACPM's members longstanding concerns with the overly conservative nature of the securitisation framework and the extent of the non-neutrality in the SEC-SA formula, we consider that the PRA should take the opportunity here to adopt Option 2 rather than Option 3. Although Option 2 goes further than is needed specifically to address the impact of the output floor (in that banks currently operating under the Standardised Approach which would be applying the SEC-SA in any case would not be impacted by the output floor anyway), we think the benefits that would flow for the UK from reducing the p-factor for the SEC-SA more generally (as has been seen with the introduction of the synthetic STS framework in the EU) mean that Option 2 would be a positive policy initiative for the UK banking sector without generating any significant risk to the banking system if implemented in the ways we discuss below, therefore aligning with the PRA's competitiveness and growth objectives. We also agree with the assertion in Paragraph 2.32 of the Discussion Paper that Option 2 is consistent with prudential goals by making it more economic (and therefore more attractive) for banks to transfer risk out of the banking system.

Notwithstanding our clear preference for Option 2, if the PRA ultimately does not decide to pursue that option, or if it proposes a level of reduction in the p-factor for the SEC-SA across the board that is lower than we discuss below is necessary to address the impact of the output floor, IACPM members are strongly of the view that some form of Option 3, similar to what is being implemented in the EU, is the minimum that is necessary to preserve the effectiveness of SRT securitisation in the UK, with all the benefits that brings to the banking system and the wider economy.

We disagree with the suggestion in Paragraph 2.47 of the Discussion Paper that Option 3 would undermine the purpose of the output floor. As we set out at the beginning of this response, we consider that the impact of the output floor on securitisation is an unintended consequence of the simple way in which the output floor is implemented in the Basel Framework which leads it to have an outsized impact on securitised exposures compared with the impact which it has on unsecuritised exposures. Nevertheless, for the reasons above, we agree that Option 2 is preferable on the basis that it also addresses a longstanding concern with the securitisation framework independent of the new concerns raised by the output floor. We also understand that the version of Option 3 which simply excludes certain securitisation positions from the Output Floor calculation is not one regulators and supervisors may wish to pursue, given the stated purpose of the Output Floor itself.

If the PRA concludes that it is not appropriate to implement Option 2 across the board, we urge it at least to implement it for the originator of a securitisation. While the output floor will also impact banks which invest in securitisation issued by other banks, in many cases they will

already not be applying the SEC-IRBA to those securitisation positions, meaning that the output floor will have less impact there than it will have on their position as originators. Further, as noted above, the information asymmetry concerns advanced to justify the non-neutrality p-factor in the first place clearly do not apply to the originator of a securitisation. Most importantly, banks do not *invest* in securitisations to manage the credit risk and regulatory requirements associated with their core banking business. However, those are precisely the reasons for originating a SRT securitisation. Thus, in terms of limiting the impact of the output floor on the core business of UK banks, reducing the p-factor in the SEC-SA at least for the originator is of primary importance.

Implementing a reduction in the p-factor would be relatively straightforward, and would require only minor, self-contained amendments to the CRR. The only real questions to be decided are whether or not to go for a "one-size-fits-all" approach or whether to have a differentiated p-factor applied for different types of securitisations. We consider this further in our response to Question 3, below.

Q3: *To what extent could the p-factor be reduced while meeting the constraints set out in paragraph 2.36? Please provide evidence that would support this assessment. Are there other constraints that the PRA should consider?*

IACPM members question the appropriateness of the constraints set out by the PRA in paragraph 2.36 of the Discussion Paper, which we consider are more arbitrary in nature and not driven by appropriate risk-based prudential considerations.

To start with the constraint mentioned in sub-paragraph 2.36(a), for the reasons discussed in the introduction to our response above, we do not think that the value of the p-factor in the SEC-IRBA necessarily dictates a lower limit to the p-factor for the SEC-SA. Although superficially the p-factor functions in a similar way in both formulae (ie, as a capital surcharge) given that the SEC-SA starts from the more conservative K_A to start with, there is no particular reason why the *rate* of the surcharge (let alone the absolute amount of that surcharge) needs to be greater under the SEC-SA than it is under the SEC-IRBA. Rather, the appropriate level of the p-factor for the SEC-SA needs to be calculated independently of that which applies for the SEC-IRBA.

Turning then to sub-paragraph 2.36(b), although the existing STS framework for traditional securitisations applies a lower p-factor than applies to non-STS securitisations, that should not be the starting point for determining the correct p-factor value for non-STS securitisations. The principle underpinning the capital treatment of STS securitisations is that the p-factor is 50% of that which applies to non-STS securitisations. Therefore, the correct approach is to determine the appropriate p-factor for a non-STS securitisation, and then to provide that the p-factor for STS securitisations is 50% (or some other reduced percentage) of that value. Indeed, while IACPM members support the principle that the p-factor for an STS securitisation is 50% of that which applies to non-STS securitisations, we consider that getting the value correct for non-STS securitisations is more important, even if that means the PRA were ultimately to conclude that the discount for STS securitisations should be less than 50%.

Finally, in relation to sub-paragraph 2.36(c), the so-called "cliff effect" is actually a function of the fact that all securitisation positions with a detachment point which is less than K_A automatically have a risk-weight of 1250%, while a 1250% risk-weight is implied for the portion of a tranche with an attachment point below K_A and a detachment point above K_A. Thus, 100% of the unsecuritised capital charge of the securitised exposure is concentrated in the tranches covering the risk up to K_A. Given that a 1250% risk-weight implies holding capital against K_A on a "one for one" basis, all that is meant by a "cliff effect" here is the risk that the actual unexpected losses on the securitised portfolio *exceed* K_A, a risk which exists regardless of whether or not the exposures have been securitised. There is, therefore, no reason why the mere fact that the exposures *have* been securitised should mean that this "cliff effect" needs to be addressed in a way which would not be the case if the exposures had not been securitised. In any case, this cliff effect is adequately addressed by the risk-weight floor which applies to the retained senior tranche, as regardless of the thickness of the placed tranche, the originator will always be required to apply a 15% risk-weight (10% for traditional STS securitisation) to that retained senior tranche *in addition to* whatever capital is being held against the tranches attaching below K_A. In addition, the W-parameter in the SEC-SA formula also mitigates the cliff effect, as an increase in the rate of defaults in the securitised portfolio will automatically increase KA and thus the risk-weight for a given tranche on a dynamic basis.

We note that in Paragraph 2.40 of the Discussion Paper the PRA suggests a possible reduction in the p-factor to 0.7 for non-retail exposures, at least where the effective number of exposures is high, but that the available data suggests that the formula for determining the p-factor for retail portfolios often leads to a p-factor value which is higher than for non-retail exposures. These conclusions are not consistent with IACPM members own experience.

As shown in the examples set out in Appendix A, which are all representative of the types of transactions which have been executed in the market going back at least as far as 2016, as evidenced in annual synthetic securitisation surveys conducted by the IACPM, the SEC-IRBA p-factor is almost always lower than 0.7, for the types of portfolios modelled therein, falling in a range between 0.34 and 0.57, with the "average" p-factor being approximately 0.5. This is the case for both retail and non-retail portfolios.

Broadly speaking, and consistent with the PRA's conclusion for non-retail exposures, the p-factor calculated under the SEC-IRBA tends to be higher where the effective number of exposures is low. This is logical, as in those circumstances, the default of individual exposures has a larger impact on the overall securitisation and suggests that there is a greater likelihood that any deficiencies in the formula that could lead to losses exceeding expectations are more likely to materialise, thus justifying a higher capital surcharge. That said, the overall impact of a lower "N" value is relatively minor once N exceeds approximately 40, which is almost always the case for SRT securitisations.

In relation to the PRA's observation that the p-factor tends to be higher for retail exposures than for non-retail exposures, we wish to make the following comments. First, as shown in the data set out in Appendix A, the PRA's observation does not appear to be correct for the examples modelled there. Secondly, while it is true that, all other things being equal, the p-factor for a retail portfolio will be more affected by a longer tranche maturity than is the case for a non-retail portfolio, this is due to the arbitrary values ascribed to the "E" parameter used

to calculate the p-factor for retail exposures. However, this does not necessarily mean that the p-factor overall will be higher, because of the lower values ascribed to the "C" parameter for retail portfolios, and the fact that the K_{IRB} for retail portfolios will often be lower than for non-retail portfolios. Therefore, there is no reason to conclude that there is less scope to apply a lower p-factor for the purposes of the SEC-SA in relation to retail portfolios.

In any case, for the reasons set out above, we disagree that the calculation of the p-factor under the SEC-IRBA should of itself influence the determination of the appropriate p-factor for the SEC-SA, and thus even if, contrary to the examples set out in Appendix A, the PRA's analysis does suggest that retail portfolios have tended to generate a higher p-factor under the SEC-IRBA, that should not mean that a lower p-factor cannot be justified under the SEC-SA. We also note that there have been very few SRT securitisations of retail exposures in the UK, so there is a limited dataset available. There is, however, more extensive data available for EU banks where there has been more SEC-SA SRT securitisations. IACPM would be happy to assist in providing additional information on such EU transactions.

It is true that by far the largest part of the SRT market in the UK at present relates to non-retail exposures, and that is therefore the segment of the market that will be most immediately impacted by the output floor. However, this is, expected to change with the introduction of Basel 3.1 which, in accordance with the proposals in CP16/22 will lead to significant increase in the risk-weights for certain retail exposures, including in particular residential mortgages and SME exposures. So, the comparatively small number of retail SRT securitisations does not indicate that it is not also important to address the impact of the output floor on these securitisations.

Turning then to the actual level of the p-factor, IACPM members do not consider that a level of 0.7 is sufficient to counterbalance the impact of the output floor. As shown in the examples in Appendix A, a p-factor of 0.7 would still generate a securitised portfolio risk-weight in the region of 45% (after applying the 72.5% output floor multiplier), roughly 2.5 to 3 times the risk-weight that applies to the corresponding tranche(s) under the SEC-IRBA. Similarly, the examples in Appendix B show the resulting senior tranche risk-weight would always exceed 70% (again, after applying the 72.5% output floor multiplier) This remains far too high for the transaction to be economically viable.

Even with a p-factor of 0.5, the analysis in Appendix A shows that the risk-weight of the securitised portfolio would still increase to the range of 30%, and data in Appendix B shows that the senior tranche risk-weights would continue to exceed 30%. Full neutralisation of the impact of the output floor would require a SEC-SA p-factor in the region of 0.3 to 0.5.

We note that the EU has chosen to apply a p-factor of 0.5 for the purposes of the output floor. Based on the illustrations set out in Appendices A and B, it is clear that this will still be challenging for EU banks, unless they are able to structure a transaction to comply with the STS framework, in which case a p-factor of 0.25 will apply.

The examples in Appendix A do indicate that the impact of the output floor *may* be lessened for rated portfolios where the SEC-ERBA may be applied. However, caution must be taken when interpreting these results. There are very few rated SRT securitisations in the market at

present, and the transactions for which ratings have been obtained are typically standardised portfolios to start with, where obtaining ratings does produce a more favourable outcome given the nature of the securitised portfolio and the way the rating models work. If ratings were obtained on equivalent IRB portfolios, this would still produce a less favourable outcome for the originator due to the need to sub-tranche what would otherwise be the single retained senior tranche, with the weighted average risk-weight of those retained senior sub-tranches exceeding the 15% risk-weight which would otherwise apply to the entire retained senior tranche. It therefore *cannot* be inferred from the examples set out in Appendix A that the impact of the output floor could always be avoided by obtaining ratings. On the contrary, for the reasons stated here, and the reasons set out in our response to Question 6, below, we consider that the disadvantages of changing the hierarchy to apply the SEC-ERBA ahead of the SEC-SA would undermine any potential benefits which that would have in terms of addressing the impact of the output floor.

In terms of whether it would be appropriate to implement different p-factors for different types of securitisations, IACPM members do not think there is significant benefit to be obtained from such an approach, which would obviously add more complexity to the SEC-SA methodology. In any case, other than the "N" parameter (which, as noted above, has a relatively minor impact on the value of p), and tranche maturity (which has a very penal effect on the p-factor for retail portfolios under the SEC-IRBA methodology), the Standardised Approach does not really provide for other variables which could be used in such a formula. Further, as shown in the examples in Appendix A, the amount of variation in the p-factor generated by the formula in the SEC-IRBA is not significant, suggesting that there is relatively little to be gained by trying to create a parallel formula for the purposes of the SEC-SA.

Contrary to the suggestion in Paragraph 4.12 of the Discussion Paper, there is actually a very high level of standardisation between the structure of synthetic securitisations in both the UK and EU markets (although there are some important differences between a typical transaction in the UK and a typical transaction in the EU , where it is common to see the use of features such as time calls, synthetic excess spread and the use of unfunded protection). Therefore, the only significant differences between synthetic SRT securitisations are the nature of the portfolio (including whether there is a replenishment mechanism) and whether it is a first loss or mezzanine protected tranche transaction. That said, please also see our response on Chapter 4 of the Discussion Paper below in relation to the scope for extending the STS framework to synthetic securitisation.

In addition to the simulations provided in Appendix A, which are a good representation of the current SRT market (based on the information collected in IACPM annual surveys), IACPM UK members did also run additional simulations on specific real-life transactions, which all come to the same conclusion.

IACPM members therefore propose that the PRA specify a single p-factor for use in the SEC-SA. Based on our modelling, this p-factor should in no case exceed 0.5 and should be in the range of 0.3 to 0.5 in order to neutralise the impact of the output floor.

IACPM members would welcome the opportunity to discuss this in more detail with the PRA.

Q4: *To what extent could option 2 address industry feedback about the interaction between the output floor and Pillar 1 capital requirements?*

If the p-factor for the SEC-SA is set at the appropriate level, as discussed in our response to Question 3, above, this would go a long way to addressing IACPM members concerns about the impact which the output floor will otherwise have on securitisations.

Q5: *What are your views of the different policy options in relation to the interaction between the output floor and Pillar 1 framework for determining capital requirements for securitisation exposures?*

Please see our response to Question 2, above.

Q6: *What would be the initial and ongoing impact on: (i) capital requirements; (ii) operational requirements; and (iii) securitisation structures of changing the UK securitisation hierarchy of methods to better align with Basel standards? Please provide any data on these impacts.*

Since the introduction of the current securitisation framework in 2019, very few synthetic SRT securitisations have been rated. The small number that have been rated have been those where it has not been possible to use the SEC-IRBA methodology for various reasons, where a credit rating has produced a more favourable outcome than the very conservative SEC-SA methodology and one of the exceptions in the existing CRR hierarchy has applied such that the bank has been permitted to use the SEC-ERBA methodology instead. The key driver for this is the lack of a synthetic STS framework in the UK. In the EU, generally, there is no need for Standardised Approach synthetic securitisations to be externally rated, due to the lower p-factor which applies under the STS framework.

IACPM members are firmly of the view that the experience since 2019 has been that there are no concerns with the SEC-IRBA methodology that require recourse to external ratings as a matter of course. This is clearly borne out not only in the performance of SEC-IRBA securitisations in the UK since then, but also in the performance of synthetic SRT securitisations in the EU, where it was common practice to apply the SSFA in preference to obtaining an external credit rating even prior to 2019.

Changing the hierarchies to place the SEC-ERBA above the SEC-SA would not of itself prevent originators from applying the SEC-IRBA to calculate their IRB capital requirements. Indeed, except for the small number of SRT securitisations for which the bank has elected to obtain an external rating it would have no impact at all on SRT securitisations, as under the Basel Framework, the SEC-ERBA only applies where a credit rating exists for the relevant tranche or may be inferred from ratings applied to other tranches of the securitisation. Thus, the impact of changing the hierarchy is therefore likely to be limited in the context of SRT securitisations, *unless* the PRA elects to pursue Option 1 (or does not implement a workable p-factor under Options 2 or 3) in relation to the output floor and the bank is required to obtain ratings of

additional mezzanine tranches to be placed with non-SRT ABS investors as discussed in our response to Question 1 above. In that case, given that the minimum risk-weight for a 5-year maturity senior tranche under the SEC-ERBA is 20%, this would further penalise the originator in that by obtaining the rating for the mezzanine tranche (and retained senior tranche) it would be subject to a 20% risk-weight on the retained senior tranche rather than the 15% that could apply under the SEC-SA with the additional mezzanine protection in place.

We also note that, given the relatively low threshold before the SEC-SA can be displaced by the SEC-ERBA under the existing hierarchy (ie, where the SEC-SA produces a risk-weight higher than 25%), in circumstances where a bank would find it advantageous to apply the SEC-ERBA to address the impact of the output floor, it is likely to be open to it to do so even without any change to the hierarchies.

Given the lack of recent experience with rated securitisations of IRB portfolios, it is difficult to assess the impact that such a change would have with any degree of confidence. This is, of course, partly because the rating models are devised and operated by the rating agencies, and until they are applied to a given portfolio, it is impossible to know what sort of outcome they will produce. To the PRA's observation in Paragraph 3.12 of the Discussion Paper, that rating models are more risk-sensitive than the SEC-SA, IACPM members are not aware of any specific evidence that it is the case. Indeed, given the conservative basis of the SEC-SA, it can be argued that it is better suited to its role as the "fallback" risk-weight formula when the SEC-IRBA is unavailable. Further, each rating agency model is different, and some will be better suited to the specifics of a given portfolio than others. Thus, while in some cases a rating agency model may produce a more accurate reflection of the risk of a given portfolio than the SEC-SA, in other cases the opposite may be the case.

Further, since the introduction of the "dual rating" requirement in CRA3, the need to obtain two ratings, and therefore the need to optimise a portfolio for three different sets of parameters (ie., the bank's own parameters, and those of the two rating agencies), as well as investor requirements, some of the risk-sensitivity that may arguably be created by applying a single rating model is likely to be lost anyway. In this regard, IACPM members do suggest that it would be helpful if the PRA were to provide that only a single rating is required for an originator in respect of retained tranches of a securitisation.

On balance, therefore, IACPM members are of the view that a change to the hierarchy would be broadly unhelpful. Given that the PRA itself acknowledges in Paragraph 3.13 of the Discussion Paper that it has limited information on the potential capital impacts of such a change, and that there is no evidence that the SEC-SA is leading to the undercapitalisation of securitisations in the UK or EU to date, we urge the PRA not to make any changes to this hierarchy.

Finally, for the avoidance of doubt, IACPM members do not in any way consider that a change in the hierarchies is an effective or sufficient response to the challenge created by the output floor. That can only be addressed through a reduction in the p-factor.

***Q7:** Do you have any feedback on the PRA's views on the scope of the UK STS framework? Please provide any supporting evidence.*

Whether or not to introduce a STS framework for synthetic securitisation in the UK is, in our view, a completely separate issue from any solution to address the impact of the output floor discussed Questions 1 to 5, above. In particular, as noted in our response to Question 2, the fact that a lower p-factor applies under the STS framework *cannot* be used as a justification for not lowering the p-factor for non-STS securitisations so as to address the output floor impact. It is only after the appropriate p-factor has been determined for non-STS securitisations that the level of reduction in that p-factor that may be warranted for STS securitisations can be determined.

The extension of the STS framework in the EU to include on-balance sheet (ie, synthetic) securitisations in 2021 was a very positive development for the EU securitisation market, and the rapid take up of the framework by originators in many jurisdictions demonstrates that it has value for both originators and investors.

While much of the focus in discussions around extending the STS framework to synthetic securitisation tends to focus on the additional capital relief afforded to originators, we disagree with the assertion commonly made that the framework does not also bring benefits for investors. In particular, the existence of the framework has helped to consolidate further transaction structures and features, providing greater standardisation and clarity for investors. That said, we agree that there is room for improvement in this regard, and we would be happy to provide more detailed feedback on this if desired.

Returning to the capital treatment, however, we disagree with the PRA's assertion in Paragraph 4.11 of the Discussion Paper that extending the STS regime to synthetic securitisation would not provide sufficient risk reduction relative to the lower capital requirements given that there is no less risk reduction than applies for traditional STS securitisation. Indeed, when the SRT-related requirements of Article 26e of the EU Securitisation Regulation are taken into account, a synthetic STS securitisation is actually *more robust* in terms of ensuring there has been effective risk transfer than a traditional STS securitisation.

In response to the PRA's observations in Paragraphs 4.10 and 4.15 of the Discussion Paper, we strongly disagree with the regular assertion that synthetic securitisation is riskier or less effective at risk transfer than traditional securitisation. Contrary to common belief, the typical synthetic SRT securitisation is actually quite simple, with fewer parties, fewer documents, and far fewer variables than the typical traditional securitisation. Further, the number of variables influencing the performance of a synthetic securitisation is much lower, being limited to the occurrence of actual defaults on the securitised exposures. Unlike a traditional securitisation, there is no need to include features such as interest or currency swaps and liquidity facilities to manage cashflow fluctuations in relation to performing exposures. Further, to the extent that the securitisation is collateralised with cash held by the originator itself or high quality securities held with an independent custodian, as is typically the case for UK synthetic SRT securitisations, and the originator is also the calculation agent for the securitisation (again, which is universally the case in the UK), there is no experience to date of such securitisations

failing to work to transfer the risk effectively. The risk transfer is real, and is backed-up by the fact that all such securitisations go through a rigorous assessment process by the PRA, which clearly mitigates the concern expressed by the PRA in Paragraph 4.13 of the Discussion Paper. Further, as noted above, there have been no examples of losses being allocated to the retained senior tranches of such synthetic SRT securitisations in the UK since the GFC (and even there, it was only in the case of a handful of securitisations that would fail to achieve SRT under the current regime securitisation regime that any losses were born by the senior tranche(s)). The PRA should be encouraging the use of this effective and cost-effective tool for banks managing their credit risk and capital requirements and this would be one way to achieve that.

Therefore, while IACPM members acknowledge that there are shortcomings with the STS framework as it applies to synthetic securitisations in the EU (as indeed there are shortcomings with the STS framework that applies to traditional securitisations), the basic principle underpinning the STS framework has merit and we would urge the PRA to consider its extension to synthetic securitisation in the UK. We would be very keen to engage with the PRA as to how such a framework could work in the UK.

This does, however, lead to an even simpler solution. Taking into account the above observations that virtually all synthetic SRT securitisations in the UK already comply with a fairly standard set of requirements and are subject to the PRA assessment process, IACPM members consider that it is appropriate for the *originator* of that securitisation to apply a lower risk-weight (or a lower p-factor and risk-weight floor) to the retained tranches, without the need for any additional criteria or classification of that securitisation. We would welcome the opportunity to discuss such an approach with the PRA.

Finally, IACPM members note that the STS framework *does* currently apply in the UK to a subset of SME synthetic securitisations through the "Article 270" regime. Although we are not aware of any UK synthetic SRT securitisations which have made use of this regime to date, it may become more relevant in the future if the PRA follows through with its proposals in CP16/22 to remove the SME support factor, thereby increasing the risk-weight for SME exposures from 75% to 100%. This is another reason why it would be appropriate for the PRA to build on this existing provision in the ways suggested above.

Q8: *What is the appetite of bank originators for buying funded or unfunded credit protection in synthetic SRT securitisation?*

We note that this question is asking about the appetite for both funded and unfunded credit protection. In our view, the strong growth in synthetic SRT securitisation over the past 10 years clearly indicates there is significant appetite from banks to use funded SRT securitisation as a tool for managing their credit risk and capital requirements, while at the same time that investors see such transactions as attractive. The attached IACPM survey of synthetic securitisations 2016-2022 illustrates this growth. It is also noteworthy that this market has been robust, notwithstanding economic headwinds over that period, most noticeably the impact of the COVID pandemic, the impact of the war in Ukraine and the rise in inflation globally. This also clearly demonstrates that any reduction in the economic viability of SRT securitisation as a result of the introduction of the output floor would have serious

repercussions for both banks and investors across the UK, while also limiting the ability of UK banks to continue supporting the wider UK economy.

Given the manifestly strong appetite for funded SRT securitisation, for the purposes of the remainder of our answers to Questions 8 to 10, we are considering only unfunded credit protection provided by private sector entities such as insurers. As the PRA is aware, there is a longstanding market for government and IFI-backed unfunded credit protection (such as that provided by the British Business Bank under its ENABLE Guarantee programme, and its various COVID-related facilities) which has been recognised as providing effective credit risk mitigation for synthetic securitisations, and we assume that the PRA has no concerns with those transactions.

Given there have not been any private sector fully unfunded synthetic SRT securitisations in the UK to date (although there have been some examples of banks purchasing unfunded mezzanine transaction in addition to their typical first loss funded protection), much of the analysis below is also based on the experience in the EU market.

The private sector market for unfunded synthetic SRT securitisation first emerged in Europe in 2018, and has grown steadily since then. It remains a comparatively niche sector. Although there is some cross-over between the funded and unfunded market, the unfunded market tends to focus primarily on those types of portfolios which are less suited to funded credit protection due to their low input risk-weights. By far the most significant such sector so far has been residential mortgages. This is of course, a key asset class for UK banks, and one that will probably have the largest RWA increase under the Basel 3.1 rules once finalised, thus indicating that the demand to access unfunded SRT protection will increase in the coming years.

Although banks' usage of unfunded protection has been clearly growing over the past years, mostly for senior mezzanine protection, different banks have shown differing appetites for such unfunded protection.

One factor which has been holding back the use of unfunded protection for SRT securitisations in the UK has been the lack of clarity from the PRA as to how it views such transactions. While clearly permitted under both the Basel Framework and the CRR, there is a perception in the market that the PRA does not permit the achievement of SRT through private sector unfunded protection, or at least does not permit this unless the SRT threshold is first achieved through funded protection. It would therefore be very helpful for the market for the PRA to clarify its position in this regard.

As discussed in our response to Question 1, above, unless the p-factor for the SEC-SA is set at around 0.3, one of the few ways in which banks can seek to mitigate the impact of the output floor (albeit that this comes at a cost) is by placing additional mezzanine tranches with insurers (ie, attaching in excess of K_{IRB} and detaching above K_A). Therefore, having clarity the treatment of unfunded protection is also relevant for the purpose of assessing the impact of the output floor. That said, IACPM members do *not* consider that this output floor impact can realistically be addressed solely through the use of unfunded mezzanine protection. Indeed, for some asset classes, there is little interest from insurers to provide unfunded protection at all and, as

outlined on page [7] and below, would create counterparty concentration risks assuming that insurers were able to absorb the required risk transfer. A reduction in the p-factor is also required.

What are the pros and cons to originators of funded versus unfunded credit protection in synthetic SRT securitisation?

The obvious advantage of unfunded protection from the originator's perspective is that it is cheaper because the insurer is not required to post collateral to cover its obligations under the protection.

This, of course, is also the primary disadvantage of unfunded protection. In the event that losses are allocated to the protected tranche, the bank needs to make a claim against the insurer and wait to be paid. It is therefore also exposed to the credit risk of the insurer, for which it is required to apply a risk-weight to the protection in the same way as if that protection was a direct exposure. This does also mean that such exposure will contribute to the bank's large exposure calculations and internal credit limits for the relevant insurer, something which provides a natural limit on the extent to which a bank can make use of unfunded protection given the relatively limited number of insurers currently active in this market. In assessing whether to pursue a funded or unfunded option, therefore balancing the benefit provided by the lower cost of the protection (which can be significantly lower than cost for equivalent funded protection) against the reduced capital benefit resulting from the need to risk-weight the protection, and the commercial impact of utilising credit lines for this purpose and therefore not having them available for other, more profitable, business with the relevant insurer.

Of course, the different risks associated with funded and unfunded protection are not specific to SRT securitisation. They apply to all credit risk mitigation, and it is therefore anomalous to apply a different treatment for unfunded protection provided in the context of SRT securitisations than applies to unfunded protection provided on an unsecuritised basis, which the PRA has clearly indicated is eligible for capital relief purposes. Indeed, this highlights a more significant issue with the way the credit risk mitigation framework works, in that it does not take into account the probability of default, or indeed the LGD, of the protected exposure alongside the risk of the protection provider. Indeed, as we discussed in our response to PRA CP16/23, while we note that the removal of the so-called "double default" methodology was a key feature of the Basel 3.1 changes, this has resulted in the credit risk mitigation framework being less risk sensitive.

The bank is also exposed to the risk that if the insurer is downgraded below Credit Quality Step 3, the protection would cease to be eligible for SRT purposes, and thus the portfolio risk would return to the originator. There is still some protection to mitigate this risk, as outlined further in our response to Question 10, below, as contractual arrangements can enable the bank to replace the insurer.

Certain types of portfolios better suited to different types of protection. Eg., low risk portfolios such as mortgages well suited to unfunded insurance protection which is more cost effective given the low likelihood of losses.

As noted above, residential mortgages have been the most common asset class for unfunded synthetic SRT securitisations to date, although there have also been transactions in other asset classes such as revolving (but largely undrawn) credit facilities, where the relatively low income generated by the portfolio means it may be difficult from a business perspective to justify the cost of funded protection.

Which assets, structures, levels of tranches in capital stack are attractive for achieving SRT or additional credit protection in an unfunded way and why?

The majority of unfunded synthetic SRT securitisations are mezzanine transactions, either where there is no funded protection at all, or where the unfunded protection constitutes a mezzanine or upper mezzanine tranche sitting above funded protection.

As noted above, this may become more relevant depending on whether the PRA adopts an appropriate solution to the output floor. If banks are required to place thicker or additional mezzanine tranches in order to benefit from securitisation under the SEC-SA for the purposes of the output floor, unfunded protection from insurers is likely to be one of the most cost-effective ways of doing so, even though it is not viable for all asset classes. This would make it important that such unfunded protection is eligible for this purpose. This is a key example of the interaction between the different proposals included by the PRA in this Discussion Paper.

Q9: *What is the appetite of credit protection providers for extending funded or unfunded credit protection in synthetic SRT securitisation?*

The funded market for synthetic securitisation has been robust for over a decade and the investor interest in the market continues to increase as it becomes a more mainstream tool for banks and asset class for investors. IACPM members agree that this market is particularly deep both in terms of appetite for different asset classes, jurisdictions and the amount of risk that can be placed.

As the unfunded market has developed since 2018, there has been a slow but steady increase in the number of insurers and insurance brokers who are active in this market. Although the market continues to be dominated by around half a dozen major players, that number is expanding over time. It is worth noting that reinsurers in particular are quite active in this market, as the nature of selling tranched portfolio protection through a SRT securitisation is in many ways quite similar to their traditional business of reinsurance, more so than is the case for insurers who are more used to providing insurance on individual exposures. However, it is worth noting that the overall capacity of the market is limited both by the amount of protection insurers or reinsurers can write, the level of sophistication that insurers or reinsurers need to have (i.e. securitisation underwriting teams) and the risk appetite for single counterparty risk as outlined in the above sections.

What are the pros and cons to credit protection providers of extending funded or unfunded credit protection in synthetic SRT securitisation?

In Question 8 above we provide the summarised pros and cons to originators which can be reversed for the purposes of credit protection providers. We would also add that for funded investors and based on the IACPM member's experience, synthetic SRT securitisation provides an investment that is typically diversified (particularly once the investor builds a portfolio of investments), private and with the potential for large deployment of capital. Contrary to Private Credit, SRT investments also benefit for the longstanding experience of banks in credit origination and client risk management and will a key instrument to increase the banks' capacity to support their clients' transition.

For unfunded investors and also based on the IACPM member's experience, synthetic SRT securitisation also provides a material diversifier to the typical non-life insurer or reinsurer balance sheet.

Who might be the providers of unfunded and funded credit protection? Are there any specific impediments to insurance companies from extending credit protection to synthetic SRT securitisation?

See above response.

One factor which makes unfunded synthetic SRT more attractive for insurers is that they treat this as business on the liability side of the balance sheet, rather than an investment on the asset side, where the Solvency II capital regime would often make holding such positions uneconomic for the insurer.

Which assets, structures, levels of tranches in capital stack are attractive for extending unfunded credit protection?

Please see our response to the corresponding sub-part of Question 8, above.

***Q10:** How and to what extent might contractual arrangements mitigate any prudential risks posed by unfunded CRM in SRT securitisations?*

Unfunded protection provided by insurers in the context of a synthetic SRT securitisation functions *very differently* from traditional credit insurance. In the first place, the drafting of the protection follows the standard conventions and approaches for funded synthetic SRT securitisation, and not the approach of traditional credit insurance. Not only does this mean that the originator's counsel has carriage of the documentation, but more importantly, the documentation will not contain many of the common, insurer-friendly features of credit

insurance such as exclusions, a claim assessment process, a duty of utmost good faith disclosure, consent rights for the insurer before the bank takes action following a default, etc. Rather all those matters remain entirely within the control of the originator in the same way as for a funded SRT securitisation. This goes a long way towards mitigating the risk that insurers may be able to rely on the various defences that exist in insurance law to avoid or delay payments following a credit event, and there has been no experience to date of insurers seeking to avoid such payments.

In addition, there are a number of additional factors which apply to mitigate the prudential risks associated with unfunded protection.

First and foremost, the originator will be required to risk-weight the protection with the risk-weight applicable to the insurer. Where that risk-weight is rating-dependent, it will also adjust as the rating of the insurer adjusts. The CRR also imposes rating thresholds in the context of unfunded SRT protection which do not apply in a non-SRT context. This requires the protection provider to have an initial credit rating which corresponds to Credit Quality Step 2, and that it maintains a credit rating which corresponds to Credit Quality Step 3. This ensures that protection can only be recognised in the SRT context against high quality protection providers.

Secondly, given that the capital benefit for the originator is also dependent on the credit rating of the insurer, many transactions will also include a mechanism to reduce the premium paid by the originator if the insurer is downgraded. Taken to its extreme, if the insurer is downgraded below a specified level, the originator will be permitted to transfer the position to a replacement insurer, or if that is ultimately not possible, to terminate the transaction. This ensures that the originator is not stuck in a transaction which no longer has the expected benefit. Of course, the originator is not forced to do so; where there may be benefit in retaining the protection (for example where the credit quality of the securitised exposures has deteriorated), the originator can keep the protection in place, even with a reduced capital benefit.

Thirdly, any SRT insurance will count towards the bank's large exposure calculations for the relevant insurer. This places a natural limit on the level of exposure which the bank can have to any one insurer (or insurance group) through SRT transactions.

Fourthly, unfunded protection is commonly provided through the use of credit insurance. This means that the originator is a policyholder, and thus benefits from the preferential ranking accorded to policy claims over general obligations of the insurer under Solvency II. Indeed, as set out in our response to CP 16/22, this is one of the reasons why IACPM members have reservations about the treatment of credit insurance more generally under the Basel 3.1 proposals, as the LGD applied to insurers under the F-IRB approach does not take this priority into account.

Finally, syndication is often used as a way of spreading the risk across the insurance market. This can take both the form of the originator executing a SRT securitisation with multiple insurers in the first place (each taking different vertical and/or horizontal shares of the risk), and the form of the insurer reinsuring its exposure in the reinsurance markets. Both

techniques help to guard against the risk that the failure of any one insurer would have an outsized impact on SRT markets.

We appreciate the opportunity to share our feedback on this consultation. If you have any questions or would like additional information, please contact the undersigned.

Yours sincerely,

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APPENDIX A
Impact of Output Floor on Securitised Portfolio Risk-Weights

Phase	SEC-SA 'p'	Asset Class	Project Finance	Large Corporate	SME (Unrated)	Auto (Unrated)
Pre-securitisation		IRB RW	67.50%	50.00%	67.00%	60.00%
		STD RW	100.00%	83.00%	85.00%	75.00%
		STD Output Floor RW	72.50%	60.18%	61.63%	54.38%
		Output Floor Impact*	**+5.00%**	**+10.18%**	**-5.38%**	**-5.63%**
Post-securitisation		Rated?	N	N	N	N
		SEC-IRBA 'p'	**0.57**	**0.48**	**0.42**	**0.57**
		Senior Attachment Point ('AP')	10.30%	7.00%	8.50%	9.70%
		Protected Tranche AP	0.00%	0.00%	1.00%	1.50%
		WA Retained SEC-IRBA RW (%)	**15.00%**	**15.00%**	**25.65%**	**27.01%**
	p=1.0	WA Retained Output Floor RW (%)	64.30%	63.77%	66.19%	56.46%
		Output Floor Impact	**+49.30%**	**+48.77%**	**+40.54%**	**+29.45%**
		Cost of Capital Increase *(versus SEC-IRBA)*	**+3.6x**	**+41.4x**	**+108.3x**	**+13.8x**
	p=0.7	WA Retained Output Floor RW (%)	40.36%	43.99%	45.97%	38.78%
		Output Floor Impact	**+25.36%**	**+28.99%**	**+20.32%**	**+11.77%**
		Cost of Capital Increase *(versus SEC-IRBA)*	**+1.5x**	**+1.9x**	**+2.3x**	**+1.9x**
	p=0.5	WA Retained Output Floor RW (%)	24.93%	30.82%	32.79%	28.00%
		Output Floor Impact	**+9.93%**	**+15.82%**	**+7.14%**	**+0.99%**
		Cost of Capital Increase *(versus SEC-IRBA)*	**+1.1x**	**+1.1x**	**+1.4x**	**+1.2x**
	p=0.25	WA Retained Output Floor RW (%)	10.88%	14.40%	20.55%	25.51%
		Output Floor Impact	**-4.13%**	**-0.60%**	**-5.09%**	**-1.50%**
		Cost of Capital Increase *(versus SEC-IRBA)*	**+0.9x**	**+0.8x**	**+1.0x**	**+1.1x**
		'p' necessary to neutralise Output Floor impact	**0.37**	**0.26**	**0.39**	**0.48**
		Senior AP (multiple of K_{SA})	1.29	1.05	1.25	1.62
	p=1.0	**Senior SEC-SA RW if Senior AP = 1.5x K_{SA}**	**73.50%**	**58.67%**	**62.97%**	**64.38%**
		Senior AP to reach Output Floor (SEC-SA) ≈ 15% (multiple of K_{SA})	**2.94**	**2.64**	**2.76**	**2.87**

Output Floor impact demonstrates effective output floor impact to institution, assuming output floor is binding for institution and calculated as 72.5% of Standardised equivalent appraoch risk weight

APPENDIX B
Impact of Output Floor on Senior Tranche Risk-Weights

	SEC-SA Risk Weight * 72.5%			
Attachment Point	P-Factor 1	P-Factor 0.7	P-Factor 0.5	P-Factor 0.25
7%	88% (*)	64%	49%	29%
9%	70%	47%	31%	15%
12%	50%	28%	15% (**)	15% (**)
15%	36%	17%	15% (**)	15% (**)

(*) The effective SEC-SA risk-weight here would be 72.5%, but for output floor purposes this would be capped at 72.5% of the unsecuritised portfolio risk-weight under Article 267 of the CRR.

(**) For output floor purposes, the effective risk-weight floor would be 10.875% (being 75% of 15%).

- The above table shows the senior tranche risk-weights calculated for different attachment points and p-factors, using the SEC-SA formula multiplied by 72.5%.
- The calculations are based on an example transaction with SA portfolio risk-weight of 100% (i.e. K_{SA} = 8%) and W (defaults) of 0%.
- Whilst this is a generic example, it is representative of the SEC-SA risk-weights which would be apply for SRT transactions if the output floor binds. For most existing SRT transactions, the weighted average portfolio SA risk-weight is equal to or close to 100% in all cases and W would have been 0 at inception.
- To illustrate this, currently under the SEC-IRBA, a SRT transaction can be structured to achieve a senior tranche risk-weight of 15% with an attachment point of 7–9% (depending on the portfolio). The table above illustrates that even with a p factor of 0.5, the senior tranche attachment point would need to be 12% to achieve a 15% RW and a p-factor of close to 0.25 would be required to effectively neutralise the impact of the output floor.
- Any material movement away from the 15% risk-weight represents a challenge to the transaction economics.