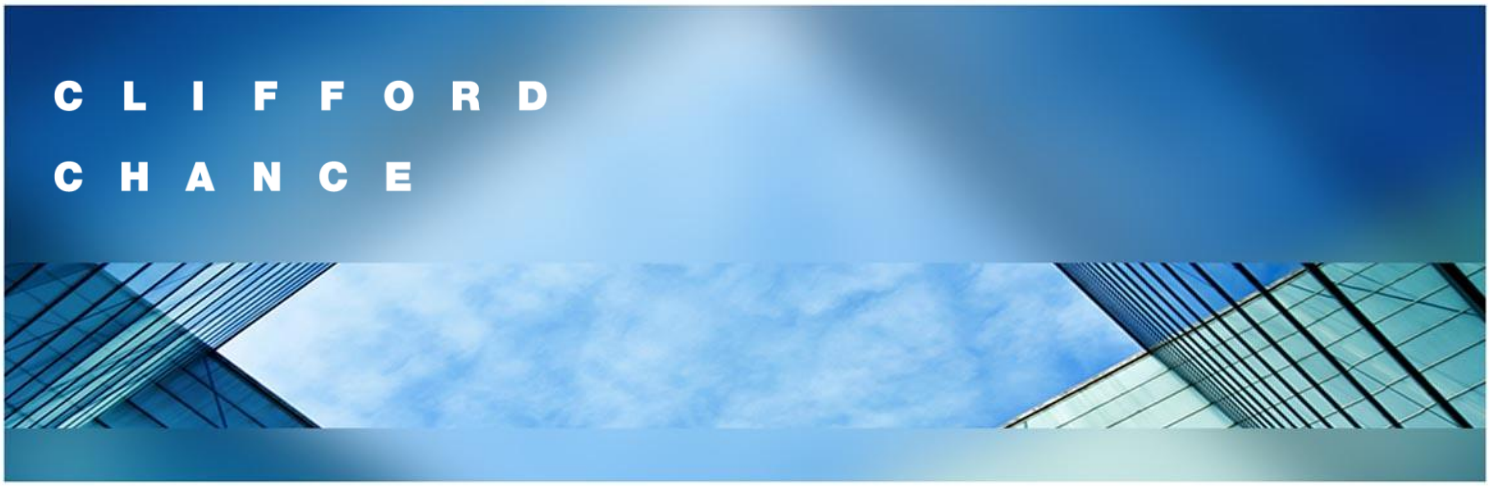


EBA REPORT ON SIGNIFICANT RISK TRANSFER IN SECURITISATION

On 23 November the European Banking Authority published its long-awaited report on significant risk transfer (SRT) in securitisation (the "**SRT Report**"). This is a follow-on from its 2017 discussion paper (the "**2017 DP**") on the same topic. The SRT Report was published with the laudable ambition of simplifying and harmonising the current complex European patchwork of approaches taken to SRT, and providing certainty and predictability to market participants seeking to structure transactions that will achieve SRT. In this briefing, we discuss the EBA's proposals and assess how much progress the SRT Report makes toward these ambitious goals.

Key issues

- The SRT Report makes a significant step towards a meaningfully harmonised SRT assessment process across the EU
- It sets out recommendations covering almost every aspect of SRT – including structural features, SRT tests and the assessment process
- The next step will be the formulation and adoption of various delegated regulations and guidelines to implement these recommendations
- The SRT Report also recommends certain amendments to the CRR, but these will presumably be on a longer time horizon, if they are adopted at all

BACKGROUND

When a bank originates a securitisation, where that securitisation involves significant risk transfer, the bank is permitted to substitute the capital requirements in respect of the positions it holds in the securitisation for its capital requirements in respect of the securitised exposures. Where, as is the case with most synthetic securitisations in particular, the bank transfers part or all of the risky first loss and/or mezzanine tranches to investors and thus only retains the senior tranche, this can lead to a significant reduction in the bank's capital requirements. While achieving a reduction in capital requirements is by no means the only motivation for executing a synthetic securitisation, ensuring that the securitisation achieves significant risk transfer is usually an important consideration in assessing the economic viability of a transaction.

The regime for achieving significant risk transfer is set out in Articles 244 and 245 of the Capital Requirements Regulation ("**CRR**"). However, that framework has long been criticised for being too vague and for allowing excessive discretion for competent authorities ("**CAs**"), with the result that there has been a lack of consistency and predictability for market participants seeking to structure transactions. These problems have been exacerbated by a lack of effective coordination across the EU (leading to different results for comparable deals, depending on the prudential views of the relevant competent authority) and the absence of an EU-wide common assessment process for banks seeking to apply for – and get feedback on applications for – SRT.

The practical result is a system where market participants are often forced to structure transactions based on little more than their best guess as to what will pass muster with their CA; those guesses often being based on a mixture of hard law, the EBA Guidelines on SRT from 2014 and industry rumour about the latest attitude of their CA.

In this context, the EBA's work in the SRT Report to clarify and harmonise this system is very welcome. The SRT Report represents an impressive and significant first step towards its ambitious goals and sets out a framework for decision-making, but does not set out hard and fast substantive or procedural rules.

Structural features that are potentially problematic and safeguards that should be helpful are highlighted, but very few of these are articulated as definitive one way or the other. Tests for SRT (including commensurate risk transfer) are articulated, but discretion remains to treat the outcomes of these tests as persuasive rather than definitive. An assessment process is articulated to give market participants certainty around SRT decisions, but significant discretion remains for CAs to delay decision-making.

Nonetheless, this is a significant step forward, and it's hard to see how the EBA could have made more progress than it has at this stage.

THE RECOMMENDATIONS

In the SRT Report, the EBA puts forward 21 recommendations, covering nearly every aspect of SRT. Broadly, these can be grouped into three categories:

- Structural features
- Tests to assess SRT and commensurate risk transfer
- The SRT assessment process

We summarise the recommendations in each of these areas below.

Structural features

Much of the EBA's work has centred around common structural features that, when included in a securitisation, could compromise the effective transfer of risk from the originator to the third party investors in that securitisation. These features include pro rata amortisation, originator call options, early termination clauses, the use of excess spread, high cost credit protection and the choice of credit events. There had been concern since the 2017 DP that the EBA might create a series of rigid rules around each of these that would make qualifying for SRT very difficult. In the end, relatively few such rules have been suggested, each of which should be workable for the market. Beyond the relatively strict rules surrounding originator call options and early termination clauses, the other structural features are all articulated as potentially problematic for SRT, but with a series of mitigating factors that – if present – would nonetheless allow the transaction to be eligible for fast-track assessment and give the transaction a better chance of qualifying for SRT recognition. The conclusions around each feature are broadly as follows:

- **Call options:** only specifically permitted call options should be considered compatible with SRT, which are:
  - clean-up calls;

  - regulatory calls (including those relating to capital rules, tax and accounting standards, but not including those triggered by changes in rating agency methodologies or central bank liquidity rules);
  - SRT calls (where SRT is not granted); and
  - for synthetic securitisations only, time calls disclosed in the initial SRT assessment and exercisable only after the initial weighted average life (WAL) of the transaction (or after expiry of the initial WAL measured from the end of the replenishment period, where applicable).

- **Early termination clauses:** as with call options, only specifically permitted early termination clauses should be considered compatible with SRT, which are:
  - an illegality event;
  - a failure to pay or other material breach of contractual obligations by the other party;
  - a collateral default (when the clause is triggered by the originator in respect of a funded credit protection arrangement);
  - insolvency of a protection seller (when triggered by the originator); and
  - insolvency of the originator resulting in material breach of servicing obligations, and no back-up servicer is appointed (when triggered by an investor).
- **Amortisation structure:** Unsurprisingly, the SRT Report prefers sequential amortisation (in that it will never be incompatible with SRT), but concludes that *pro rata* amortisation structures can be compatible with fast-track assessment and the granting of SRT provided that triggers are included to switch back to sequential amortisation should the portfolio not be performing in line with original expectations. The SRT Report lists a number of forward- and backward-looking triggers, and recommends the inclusion of at least one trigger of each type appropriate to the structure of the transaction in order to maintain compatibility with SRT. However, in most cases, the report does not provide any calibration of these triggers, meaning significant uncertainty remains as to the level at which they should be set. The EBA has recommended that this is a subject which could be addressed in future EBA guidelines.
- **Excess spread:** Excess spread is in principle compatible with SRT and with the fast-track assessment process provided that certain requirements are met. These include a definition of excess spread in the documentation and a clear representation of how it is allocated in the waterfall. In addition:
  - traditional excess spread: the transaction should use only the actual excess spread generated by the portfolio, and the originator should not guarantee a fixed level of excess spread, or
  - synthetic excess spread: a fixed annual amount should be committed to absorb losses on first-loss basis.

  Importantly, the report permits the use of synthetic excess spread on either a "use it or lose it" basis or a "trapped" basis and does not set a maximum amount of synthetic excess spread that can be committed for any given period. However, the amount and basis for use of excess spread will still be relevant because they are taken into account in the tests for commensurate

risk transfer (as discussed below) and, broadly speaking, the higher the amount committed to synthetic excess spread, the more difficult it will be to satisfy those tests.

- **Cost of protection:** This concern applies to synthetic securitisations only. The SRT Report sets out a number of indicia of overly high cost credit protection. These are:
  - the protection payments expected to be received by the originator are lower than the protection fees paid by the originator in an adverse scenario;
  - the cost of the transaction is higher than the originator's cost of capital; and
  - the remaining portfolio income after of the protection fees is not aligned with the risk profile of the positions retained by the originator.

  Where any of these are present, the SRT Report recommends against allowing fast-track assessment. The SRT Report also recommends contingent protection premiums, but permits upfront premium payments where they are fully paid by a third party, fully recognised in the P&L at the payment date or paid in the context of certain state-sponsored guarantee schemes.
- **Credit events:** The SRT report concludes that no recommendations are necessary in this respect as the minimum credit events are already set out in the CRR.

In addition to setting out the features described above, the SRT Report also requires an originator to conduct a quantitative assessment of the impact of these features on the transaction, including identifying what constitute the "base case" and "adverse" scenarios which are particularly relevant for the amortisation, excess spread and cost of protection features.

Tests to assess SRT and commensurate risk transfer

The SRT Report goes into some detail about the existing legislated tests for SRT, which include the mezzanine test (selling at least 50% of the risk-weighted amounts of the mezzanine tranches) and, where there are no mezzanine tranches, the first-loss test (selling 80% of a first-loss tranche thick enough to exceed a reasoned estimate of the expected losses on the securitised exposures by a substantial margin. In addition, SRT can be achieved without passing these tests where the CA nevertheless considers that the resulting reduction in the originator's capital requirements is commensurate with the risk transferred to third parties, although in practice this approach is extremely rare. Conversely, even if the mechanical tests are passed, SRT can be refused by the relevant CA on the basis that commensurate risk transfer is not achieved.

Unsurprisingly, then, the SRT Report concludes that the current legislative arrangements are not sufficient either in terms of ensuring that significant risk has been transferred or in terms of providing sufficient guidance to market participants and competent authorities. To remedy that, the EBA starts by clearly articulating the assumptions underlying the tests. For the mezzanine test, the assumption is that the first-loss tranche will represent the expected losses (EL) on the securitised assets and the mezzanine tranches will represent the regulatory unexpected losses (UL). For the first-loss test, the assumption is that the first-loss tranche is thick enough to represent all of the EL plus the

majority of the UL. In each case, though, there are no explicit safeguards to ensure these starting assumptions are complied with. Nor, in the case of the first-loss test, is there any guidance on the meaning of a "reasoned estimate" of EL or quantification of what constitutes exceeding it by a "substantial margin". Finally, the current legislative tests do not have adequate focus on the sustainability of the SRT over the life of the transaction or the commensurateness of the risk transfer.

Accordingly, the SRT Report recommends a number of additional measures to address these deficiencies, including:

- **Minimum first-loss tranche thickness:** for the first-loss test, the SRT Report recommends a minimum thickness equivalent to the lifetime EL of the underlying exposures plus 2/3 of the UL. For this purpose, the thickness of the first loss tranche includes the amount of losses absorbed (or to be absorbed) by excess spread and (in traditional securitisations) losses already absorbed at the time of securitisation by a non-refundable purchase price discount (NRPPD) on the portfolio.
- **Methods for the calculation of lifetime EL (LTEL) and UL:** broadly, lifetime EL on internal ratings-based (IRB) portfolios should be calculated using IRB parameters. On standardised (SA) portfolios, originators should apply accounting standards such as expected credit loss provisioning, unless the CA requires something different. In each case, cash flows should be modelled using the methodology set out in the EBA's Guidelines on weighted average maturity. UL should be calculated by reference to the originator's CRR total capital ratio of 8%, without taking into account any Capital Requirements Directive (CRD) capital buffers, meaning the UL on a given portfolio will be the product of the risk-weighted exposure amount on that portfolio multiplied by 8%,
- **Methods for allocating LTEL and UL to tranches:** the SRT report sets out a methodology for allocating losses to tranches using asset and liability cash flow models, requiring the modelling of evenly loaded losses over the life of the transaction and back-loaded losses, where 2/3 of the amount of overall defaults takes place in the last 1/3 of the transaction's life. In any case, UL should always be assumed to take place in full in the last year of the transaction, after the EL has been realised and allocated.
- **Two new tests of commensurate risk transfer:** Finally, the EBA recommends the introduction of two new tests to ensure commensurate risk transfer, which is currently undefined in the CRR. These would be a principles-based approach ("**PBA**") test and a quantitative commensurate risk transfer ("**CRT**") test.
  - The PBA test aims to ensure that at least half the regulatory UL on the underlying portfolio is transferred away from the originator. Adjustments are made to deduct losses absorbed (or to be absorbed) by excess spread or NRPPD from the amount of UL transferred.
  - The CRT test, on the other hand, measures the capital relief to the originator as a proportion of the capital on the underlying portfolio (Ratio 1). It also looks at the proportion of LTEL and regulatory UL on the underlying portfolio that is allocated to securitisation positions transferred away from the originator (Ratio 2). The test is passed if Ratio 2 is at least as big as Ratio 1. The logic behind this is clear: the proportion of capital relief should not be greater than the proportion of losses (LTEL plus UL)

transferred to third parties. Once again, however, the amount of LTEL and UL transferred is reduced by the amount losses absorbed (or to be absorbed) by excess spread or NRPPD.

The devil, however, is very much in the details, and market participants will want to examine very carefully whether these tests can sensibly be met once the effect of other factors such as specific credit risk adjustments, NRPPD and (especially) synthetic excess spread is taken into account.

- **NPE securitisations:** The SRT Report also includes adjustments to the SRT tests to account for the particular features of NPE securitisations – notably the often significant NRPPDs associated with these transactions. For these purposes, the SRT Report acknowledges that the risk-absorbing effect of the NRPPD should be recognised for the purposes of adjusting minimum tranche thickness (such that the minimum thickness requirement would effectively cease to apply where the NRPPD exceeds LTEL + 2/3 regulatory UL). Adjustments are also made to the methods to calculate LTEL and UL (taking into account expected adjustments to Basel standards banning the use of foundation IRB inputs for NPE securitisation capital calculations). Finally, adjustments to the PBA and CRT tests are suggested to account for the risk-absorbing effect on the UL of NRPPD and for the recognition of discounts on the initial sale of mezzanine tranches to third parties to the extent these discounts have been recognised in the P&L of the originator.
- **Timing and grandfathering:** Helpfully, the SRT Report is clear that these tests for SRT (including the PBA and CRT tests) should only be run once – at the outset of the transaction, and repeated only when there are amendments to the securitisation, rather than being re-tested periodically throughout the life of each transaction. Unhelpfully, however, this does mean the tests would need to be re-run when almost any amendment is made, even minor amendments that have no impact on the original SRT analysis. The SRT Report is also clear that these tests should be applied prospectively only – with previously-granted SRT remaining undisturbed for the life of the transaction or until there is cause to reassess (e.g. a material amendment to the deal).

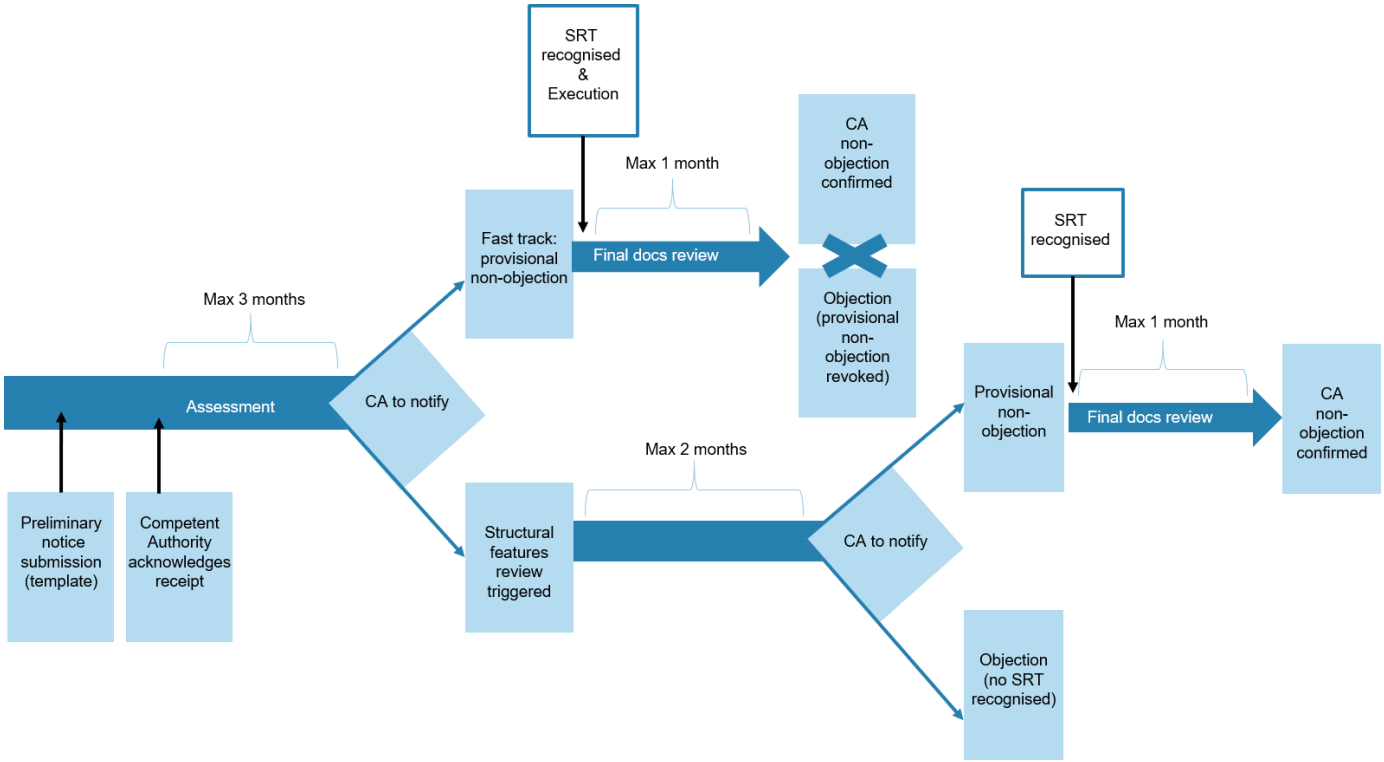
The SRT assessment process

The final area where the SRT Report makes practical recommendations for adjusting the SRT regime is in the process for assessment of SRT. The essence of these recommendations is to set out a formal framework to ensure that authorities get the information they need to make an informed assessment in a timely manner, and to ensure that market participants are given regulatory feedback from their CA in a timely and structured manner. The elements of this process are set out below and summarised in the diagram below (reproduced from the SRT Report):

- **Submission of a preliminary notice:** This should take place at least three months prior to the intended closing of the transaction. This notification is to be given by completing a template and should be accompanied by as much information as possible, including a self-assessment of SRT and (where possible) preliminary drafts of the transaction documents. The preliminary notice should be acknowledged by the CA within a week, confirming whether they consider it to be complete or requesting any missing information.

- **Fast-track:** Where transactions either (i) do not contain any of the structural features set out above or (ii) include such structural features together with appropriate safeguards, then the transaction should be eligible for fast track assessment, leading to provisional non-objection (which can be communicated to the market) within three months of acknowledgment of the preliminary notice. The fast-track should also be available for most repeat transactions (e.g. a series of transactions done off the same programme). The expectation is that there will be an ongoing supervisory dialogue during this period, with CAs endeavouring to provide timely feedback on any identified structural impediments to achieving SRT.
- **Structural features reviews:** Where transactions contain either structural features mentioned above without appropriate safeguards, or they contain novel structural features, the CA will normally require a structural features review, for which an additional two months should be allowed. This will also normally be required for "first time" transactions by originators new to SRT transactions or new to the particular type of securitisation or asset class. Particularly large transactions and NPE transactions will likewise normally be sufficiently complex to require a structural features review.
- **Freezes and stopping the clock:** In order to give CAs sufficient certainty and time to review documentation, there is an expectation that final versions of the SRT test calculations and draft documentation should be submitted no later than two months after the start of the process (or such later date as corresponds to the length of the structural features review). Following this, no major changes should be made. The CA would then have a month to complete the initial review. The CA can, however, stop the clock on the assessment period where it has not received the required calculations and final draft documents to start the freeze period, where significant changes are made after the start of the freeze period or while waiting for the originator to make changes or provide additional information.
- **Provisional non-objection:** Following the initial three-month assessment period (or five-month period where there is a structural features review), the CA then provides a provisional notice of non-objection or a notification that SRT is not recognised, stating the reasons for not recognising SRT. According to the SRT Report, in the absence of any notification, the originator should be entitled to claim capital relief as if it had received a preliminary non-objection notice, and with the same expectation of getting a final non-objection notice. This would be an especially useful feature for market participants, although it is hard to see how it would be enforced in practice where a CA is simply running behind schedule and concludes SRT should not be granted in the intervening period.
- **Final decision:** Following the provision non-objection, the securitisation should be executed and the transaction documents submitted to the CA no later than 7 days after execution. The CA should then confirm final non-objection within one month of submission, unless (i) the final documents deviate materially from the drafts made available during the assessment period; (ii) the assessment was made on the basis of false, insufficient or misleading information; or (iii) granting SRT could have a severe detrimental effect on the originator's safety and soundness in the judgment of the CA (although query why this last circumstance would arise at such a late stage in the absence of the first two circumstances). In case (iii), it is expected that the originator would be entitled to exercise a regulatory call.

- **Executed transactions:** A similar process and timeline (minus the need for draft documents and freeze periods applies where an originator decides to seek SRT recognition for a transaction previously executed.



THE FUTURE

The final element of the SRT Report is a series of recommendations for amendment to the CRR. In this section, the EBA points out the shortcomings of the existing legislated SRT tests and suggests that both the mezzanine test and the first-loss test could be replaced by a test "along the lines" of its suggested PBA test. It goes on to put the case that a legislated PBA test might obviate the need for a permission-based process for assessing commensurate risk transfer and the CRT test suggested above as well.

The EBA also suggests:

- reassessing the treatment of positions whose attachment and detachment points straddle K_{IRB} or K_A (as the case may be);
- imposing capital requirements as a tranche in respect of synthetic excess spread (a proposal that looks as though it may go forward in some form as part of the current Capital Markets Recovery Package currently in final legislative negotiations);
- bringing SRT transactions using the "full deduction option" into line with other SRT transactions by harmonising notification requirements and rules around structural features; and
- giving the EBA a monitoring role in respect of new structural features of securitisations and SRT, or variations of existing ones, in order to avoid divergence of supervisory approaches and ensure a uniform application of the SRT framework across the EU.

CONCLUSION

The scope of the SRT report is wide and its aims are ambitious. It does a comprehensive job in addressing the various aspects of SRT and makes a significant contribution to the process of harmonising SRT rules across the EU. Whether the substantive rules (and, in particular, the new CRT test) are compatible with market realities remains to be seen, and market participants would be well-advised to start the work of checking this now, as early intervention would provide the best chance of tweaking any potentially problematic rules before they take effect.

Finally, the nature of the recommendations in the report clearly intends to strike a balance between prescriptive rules (likely to promote harmonisation) and leaving discretion (necessary to allow CAs to adapt rules to particular – and often unforeseen – circumstances). We are hopeful that this will lead to greater harmonisation and transparency in the relatively short term, and better, more uniform decisions on SRT in the medium term.

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