

EBA Proposes Limits on Capital Relief for Securitisations

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European Banking Authority proposes new structural and quantitative tests for significant risk transfer transactions

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Overview

The EU Capital Requirements Regulation, which came into effect in January 2014,¹ mandated the European Banking Authority to report by 2 January 2021² on the regulatory approach to granting capital relief for transactions involving the transfer of significant credit risk to third parties in traditional and synthetic securitisations. In the CRR, transactions that qualify for capital relief are referred to as significant risk transfer (“SRT”) transactions.

On 23 November 2020, the EBA published its final report³ (the “SRT Report”) which sets out detailed recommendations for consideration by the European Commission for new delegated and primary legislation relating to:

1. assessment of structural features of securitisation transactions;
2. the content and application of SRT quantitative tests; and
3. the SRT assessment process in relation to individual transactions.

1. Structural features of securitisation transactions

The SRT Report identified a list of six ‘structural features’ that will need to be assessed in each SRT transaction. If a transaction contains additional structural features, those will also need to be assessed.

Pro rata amortisation: when all or major part of the senior tranche is retained, pro rata amortisation should only be used in conjunction with clearly specified contractual triggers for a switch to sequential amortisation. For performing securitisations, the triggers should be both backward-looking and forward- looking and must include triggers selected from a list contained in the SRT Report.⁴ The SRT Report recommends that it should develop more detailed guidelines on amortisation triggers.

Call options: the SRT Report recommends that only the following call options should be included:

- (a) 10% clean up calls of the kind currently permitted;⁵
- (b) regulatory calls relating to change of law, regulation, tax, accounting, rating agency methodology and central bank collateral frameworks;
- (c) time calls in synthetic securitisations occurring after the end of the weighted average life of the underlying exposures; and
- (d) calls arising from the competent authority rejecting SRT treatment in its initial supervisory assessment.

The SRT Report further recommends that a transaction with other call options should be automatically ineligible.

¹ Regulation (EU) 575/2013 of 26 June 2013

² Originally, the EBA was required to report its findings by 31 December 2017. In September 2017, the EBA published a Discussion Paper on significant risk transfer, in part fulfilment of this mandate. The timing for the final report was amended by a subsequent amendment to the CRR.

³ EBA/Rep/2020/32

⁴ Recommendation 2 at paragraph 57

⁵ CRR, Articles 244(4)(g) and 245(4)(f)

Excess Spread: this spread should be clearly defined. In synthetic securitisations where excess spread provides first loss credit enhancement, the originator should commit to a fixed annual nominal amount of excess spread available to absorb losses in the transaction. In traditional securitisations, the excess spread payable to the originator should not be more than the actual excess spread generated by the portfolio of securitised assets, and the originator should not guarantee a fixed level of excess spread. The SRT Report does not set a maximum amount of synthetic excess spread that can be committed to a transaction for any particular period, but the amount and basis for the use of excess spread will be taken into account in the tests for determining whether a transaction achieves “commensurate” risk transfer, which we discuss below. In short, the higher the amount committed to synthetic excess spread, the more difficult it is likely to be to satisfy the requirements for a “commensurate” risk transfer.

Early Termination Events for synthetic securitisations: the SRT Report recommends that these should be limited to:

- (i) illegality;
- (ii) failure to pay;
- (iii) material breach of contract;
- (iv) insolvency (but in the case of originator insolvency, only if there is a material servicer default and no back-up servicer is appointed); and
- (v) collateral default in the case of funded protection exercisable by the originator only.

The SRT Report also recommends that a transaction with other early termination events should be automatically ineligible.

Cost of Credit Protection for synthetic securitisations: the SRT Report recommends that a structural features review should be carried out (and recommends against fast-track assessment) if:

1. the cost of protection exceeds the payout that could be received by the originator;
2. the cost of capital relief of the transaction is higher than the originator’s cost of capital; or
3. the net portfolio income minus the premium paid net of payouts is less than the income from an investment with a comparable risk profile (or alternatively put, if the net portfolio income is not aligned with the risk profile of the exposures retained by the originator).

The SRT Report recommends that upfront premiums should be permitted only where they are

- (i) fully paid by a third party;
- (ii) fully recognised at the payment date; or
- (iii) paid under a guarantee scheme provided under the law of a Member State and benefiting from a counter-guarantee from public sector entities such as a government, central bank or multi-lateral agency.⁶

Protection premiums should be structured as contingent on the outstanding amount of the protected tranche and there should be no form of guaranteed premiums, rebate mechanisms or other similar feature that may avoid allocating losses to the investor. In particular, the premium should not increase if the level of the credit risk of the securitised portfolio increases.

Credit Events for synthetic securitisations: The SRT Report does not recommend changes to the minimum requirements relating to credit events already set out in the CRR.⁷

Certain aspects of the structural recommendations would require amendment to the CRR itself, so primary legislation. For example, Level 1 legislation would be required to extend the proposed ban on certain call options and termination events to circumstances where an originator is seeking to enter into a full deduction transaction rather than a significant risk transfer transaction.

⁶ See full list in Article 214(2) CRR

⁷ Articles 215 and 216 CRR

2. SRT tests

The CRR currently contains two quantitative tests to assess the ‘significance’ of risk transfers in SRT assessments: the mezzanine and the first-loss tests (the “**SRT Tests**”).

The SRT Report is critical of aspects of the SRT Tests. For example, the tests provide for a point-in-time assessment of the significance of credit risk transfer to third parties, but they do not explicitly consider the impact on the assessment of SRT of the development of exposures and positions relevant to the securitised portfolio over the term of the transaction. In order to avoid volatility of capital ratios, the EBA proposes that the assessment of SRT should be sustainable over the life of the transaction.

LTEL: The SRT Report recommends adopting a model-based approach to the calculation of lifetime expected losses (“**LTEL**”) on securitised portfolios using an internal ratings-based approach or, where the standardised approach applies, by applying expected credit loss provisioning on the relevant portfolio based on accounting standards.⁸

Regulatory UL: Regulatory unexpected losses (“**UL**”) of the securitised portfolio should be the result of multiplying the risk-weighted exposure amounts (“**RWEA**”) of the securitised portfolio by the total capital ratio of 8 per cent.⁹ Capital buffers under the CRD should be excluded from the calculation.

EEVES: For the purpose of allocating LTEL and UL to tranches of credit risk, the equivalent exposure value of excess spread (“**EEVES**”) should be treated as a tranche that would absorb losses throughout the life of the transaction. EEVES will only include excess spread that absorbs losses, so excess spread that the model indicates would be paid to the originator should not be treated as EEVES.

Guidelines on Weighted Average Maturity: The EBA recommends that asset models and liability models are based on its recently published guidelines on weighted average maturity¹⁰ (the “**WAM Guidelines**”). These should be used, with the adjustments set out in the SRT Report, for the calculation of LTEL and EEVES, and the allocation of LTEL and UL to tranches.

Minimum thickness of first loss tranche: In line with the criticisms of the old tests and the proposed adjustments to the calculation of LTEL, EEVES and UL, the SRT Report proposes some amendments to the SRT Tests, most notably supplementing the first-loss test with a requirement that the first-loss tranche has a minimum thickness, in part determined by reference to expected losses of the securitised portfolio over the lifetime of the transaction. So in synthetic securitisations, the SRT Report recommends defining a minimum thickness of the first-loss tranche determined on the basis that the nominal value of the first-loss tranche plus the EEVES should be equal to or greater than the LTEL and two thirds of the regulatory UL of the applicable securitised portfolio. This effectively treats the EEVES as a retained position. The proposed test is the same for traditional securitisations except that credit can be given for the risk-absorbing effect of EEVES (provided that the pricing of the tranches is at market) and any non-refundable purchase price discount.¹¹

Commensurateness: The most significant change proposed to the quantitative assessment of SRT transactions relates to the assessment of commensurate risk transfer. In addition to the SRT Tests, the CRR requires the reduction in RWEA or own funds requirements which the originator would achieve by means of a proposed securitisation to be justified by a “commensurate transfer of credit risk” to third parties. In the words of the EBA this “involves a comparison of the RWEAs or own funds requirements of the originator pre and post securitisation”.

⁸ If a competent authority considers the accounting standards approach would be inadequate for a particular portfolio, it can adopt an alternative method.

⁹ See CRR, Article 92

¹⁰ EBA Report on the Determination of the Weighted Average Maturity of the Contractual Payment due under the Tranche: EBA/GL/2020/04

¹¹ SRT Report, paragraph 119

While the CRR contains no specific tests or benchmarks for the concept of “commensurateness”, it states that the competent authorities may have regard to it in determining that securitisations do not achieve SRT on a case-by-case basis. This has resulted in a divergence of approaches by the various EU competent authorities to the measurement and assessment of “commensurateness”.

To address this, the EBA proposes two new commensurate risk transfer tests (“**New Tests**”) which are to be conducted as part of the initial assessment of risk transfer transactions:

- (i) a principles-based approach test (the “**PBA Test**”) whereby a minimum of 50% of the regulatory ULs of the securitised portfolio should be transferred to third parties; and
- (ii) a quantitative test (the “**CRT Test**”) that would measure the commensurateness of the risk transfer.

The introduction of these tests may require amendments to the CRR.¹²

The PBA Test:

$$0.5 \leq \text{Ratio} \frac{\text{Regulatory ULs on transferred positions}}{\text{Regulatory ULs of the securitised portfolio}}$$

Where the:

- (a) **Numerator:** should take into account the allocation of LTEL and regulatory UL into tranches in accordance with SRT Report and the WAM Guidelines. In particular the allocation should reflect any loss-absorbing EEVES or non-refundable purchase price discount; and
- (b) **Denominator:** is the
 - (i) regulatory ULs of the underlying portfolio calculated in accordance with the modelling as recommended in the SRT Report (by reference to the originator’s CRR minimum total capital ratio of 8% without taking into consideration the Capital Requirements Directive’s capital buffers), *minus*
 - (ii) (in traditional securitisations) non-refundable purchase price discount to the extent that it absorbs ULs, *minus*
 - (iii) (in traditional securitisations) EEVES to the extent that it absorbs ULs and the market test is met.

The CRT Test:

$$\text{Ratio 1} \leq \text{Ratio 2}$$

$$\text{Ratio 1: } \frac{(\text{capital presec.}) - (\text{capital post sec.})}{(\text{capital presec.})}$$

$$\text{Ratio 2: } \frac{(\text{LTEL} + \text{reg. UL}) \text{ on transferred positions}}{(\text{LTEL} + \text{reg. UL}) \text{ of the securitised portfolio}}$$

¹² SRT Report, paragraphs 211 to 214

“**capital presec. in Ratio 1**” refers to the pre-securitisation own funds (i.e., regulatory capital) requirements on the securitised portfolio including:

- (a) regulatory capital deductions calculated in accordance with the general credit risk framework;
- (b) the indirect effect on regulatory capital of the specific credit risk adjustments made on the securitised exposures prior to the securitisation [and their eventual derecognition post-securitisation in accordance with applicable accounting standards];
- (c) the effect of deductions on regulatory capital due to under-provisioning in the case of IRB exposures.¹³

“**capital post sec. in Ratio 1**” refers to post-securitisation regulatory capital requirements and deductions:

- (a) after application of the caps on the retained positions¹⁴calculated in accordance with the securitisation framework;
- (b) including the specific credit risk adjustments that remain on balance sheet where there is no accounting derecognition; and
- (c) taking into account the impact of any non-refundable purchase price discount on the originator’s profit and loss account.

EEVES in synthetic securitisations is not included in the regulatory capital calculations, although the EBA recommends that the CRR is amended in this respect.

“**Ratio 2**” measures the risk transferred to third parties throughout the life of the transaction, being the sum of the amount of the LTEs and regulatory ULs allocated to all the positions that have been transferred to third parties compared with the amount of the LTEs and regulatory ULs of the securitised portfolio. In this respect the LTEL and UL in the denominator should be reduced by the loss- absorbing effect of:

- (a) specific credit risk adjustments kept on balance sheet and offset from the exposure value of a 1,250% risk-weighted tranche retained by the originator;
- (b) in traditional securitisations, the part of any non-refundable purchase price discount that absorbs losses; and
- (c) in traditional securitisations, EEVES if the market test is met.

3. SRT assessment process

The EBA recommends that supervisory assessments follow a dual-track process where ‘qualifying securitisations’ are allocated to a fast-track approval system, whereas ‘non-qualifying securitisations’ will be subject to closer review. Triggers for closer review relate to transactions involving:

- structural features described in the SRT Report without all recommended safeguards;
- new structural features or variations on the structural features described in the SRT Report;
- securitisations of non-performing exposures;
- the first transaction by an originator; and
- an issuance amount or consolidated capital relief over a specified annual aggregate amount.

¹³ See CRR Article 36(1)

¹⁴ See CRR Article 267 and 268

Timing of assessment

The SRT Report recommends that the SRT assessment period should start on the date on which the relevant competent authority has acknowledged receipt of a complete preliminary SRT notice and has a maximum length of three months from that date (instead of the one month period suggested in the SRT 2017 discussion paper).

Notwithstanding the above, the relevant competent authority should be able to extend the length of the assessment period up to a maximum of five months for securitisations that do not qualify for the fast-track.

By no later than two months from the date on which the SRT assessment period commenced, the originator should submit final versions of (i) the calculations for the quantitative tests, and (ii) the transaction's draft documents. After the start of this 'freeze period', the securitisation's structure and draft documents should not undergo any major changes without the relevant competent authority's prior consent and an appropriate safeguard in place.

The SRT Report also recommends that the relevant competent authority should have the power to stop the clock on the assessment period in certain cases.

Next Steps: The European Commission will now consider the recommendations made in the SRT Report. It is also worth bearing in mind that the competent authority for the systemically important eurozone banks is the European Central Bank, so it is to be hoped that if the Commission accepts the recommendations contained in the SRT Report and proposes the necessary Level 1 and Level 2 legislation, the approach to the assessment of significant risk transfer will be consistent across the EU banking sector (and in particular, the larger eurozone banks). It remains to be seen, however, whether the European Commission will accept and proceed with the recommendations. The SRT Report is comprehensive and ambitious, but market commentators are already signalling that it is not realistic, and the recommendations are, in a number of cases, not consistent with many existing transactions. If legislation implementing some or all of these recommendations is passed, existing transactions would typically benefit from "grandfathering" provisions. However, originators of and investors in significant risk transfer transactions should pay attention, now, to some of the structural features and tests in existing transactions which the SRT Report calls into question.

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