afme/ Finance for Europe

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Association for Financial Markets in Europe (AFME) comments on European Banking Authority (EBA) Consultation Paper: Draft Regulatory Technical Standards on the conditions to allow institutions to calculate K_{IRB} in accordance with the purchased receivables approach under Article 255 of Regulation (EU) 2017/2401 amending Regulation (EU) No 575/2013 (19 June 2018)

1. Introduction

This document sets out AFME's response to the EBA's Consultation Paper dated 19 June 2018 (the **"Consultation Paper"**) on Draft Regulatory Technical Standards (**"RTS"**) on the conditions to allow institutions to calculate K_{IRB} in accordance with the purchased receivables approach under Article 255 of Regulation (EU) 2017/2401 (the **"CRR Amending Regulation"**) amending Regulation (EU) No 575/2013 (the **"CRR"**). In this response, unless otherwise specified, capitalised terms and acronyms are used with the same meanings as in the Consultation Paper, references to any Article refer to that Article of the draft RTS and references to any Article of the CRR refer to that Article of the CRR as amended by the CRR Amending Regulation.

2. General comments

We thank the EBA for presenting a proposed approach that generally seems to be workable and aims to enable institutions to apply the SEC-IRBA when acting as investors in securitisations. In particular, we appreciate the EBA's proposing an exception from the requirement for an institution to have used the model for three years before applying for supervisory approval, and the express allowance for some expert judgement when using proxy data to estimate PDs & LGDs.

We do have a number of comments and questions on specific aspects of the proposal, which are set out below in our responses to the questions set out in the Consultation Paper.

We agree with the principle of a separate rating system for purchased receivables, including the so-called "top-down" approach in which, under appropriate conditions, retail risk quantification standards are applied in relation to non-retail as well as retail exposures. However we also think that a carve-out should be provided for exposures exceeding a defined concentration limit in each transaction. For these exposures, a line-by-line approach is still necessary and should be allowed. In addition, the concentrated exposures subject to the exception should not prevent the rest of the portfolio from being eligible for use of retail risk quantification standards.

Moreover, we ask that the EBA provides further guidance for setting up and applying a rating system for purchased receivables taking into account the special attributes of such portfolios. The detailed guidelines issued in November 2017 for the estimation of PD and LGD do not seem appropriate for purchased receivables portfolios.

We believe that in practise the rule that all existing IRB requirements apply except as otherwise provided in the RTS will not be realistic for LGD derivation in the context of purchased receivables, where there is often only aggregated LGD information available and that information would not be compliant with LGD IRB requirements. We therefore think that for the purchased receivables approach to work in practice it needs to include the

flexibility to use a conservative fixed pool LGD. On this point, we note that both the current CRR and amended CRR offer a solution, with a fixed LGD of 50% that can be used for the SFA (Article 262(2) of the current CRR) and for SEC-IRBA Article 259(6) of amended CRR). We therefore propose that this fixed LGD of 50% could be also used for the LGD input in K_{IRB} for the purchased receivables approach if there is not enough information otherwise available to derive the pool LGD.

Apart from the substantive conditions of the securitisation purchased receivables approach, it is important to clarify and streamline the process for banks to be allowed to use the approach so that banks can implement it together with or during the transition period for the revised securitisation framework.

The final technical standard should confirm that, if an institution has relevant IRB permissions but is not able to apply the SEC-IRBA (including the securitisation purchased receivables approach) to its investment in a particular transaction, it should then apply the SEC-ERBA or the SEC-SA in accordance with the hierarchy set out in Article 254 of the amended CRR.

3. Responses to questions in Consultation Paper

Q1: Do you agree with the requirement that a rating system shall be exclusively used for securitised exposures that the institution does not service, i.e. for the exposures that are in the scope of these draft RTS?

We agree in general with the EBA's proposed approach to defining the scope of application of the securitisation purchased receivables approach. The EBA should consider allowing an institution to use this approach also where it is the servicer but is not the originator of the securitised assets and does not have sufficient data available to use the regular IRB model.

The Consultation Paper introduces a binary approach according to the role the institution performs in the securitisation – that is, whether the institution is or is not the servicer of the securitised exposures. It aims to provide different methods of calculation according to the level and types of data available to the institution based on its role in the securitisation. This effort is valuable, because the information set available for an originator which services the securitised assets is significantly different from the one an investor may have. Where the institution is the originator and servicer of the underlying assets, it should have sufficient data to be able to use its own internal models to calculate PD and LGD. The information required for these internal models is not likely to be available where the institution is not the originator and servicer and becomes exposed to the underlying assets as an investor in the securitisation transaction. Additionally, for certain asset classes there may be a question whether the servicing and collection efforts will be the same depending on whether the institution is or is not the servicer.

We also agree with the proposal in the Consultation Paper to allow for mixed pools, where an institution is the servicer with respect to some but not all of the securitised assets, and would apply the securitisation purchased receivables approach for those assets as to which it is not the servicer.

In the case where an institution is the servicer but is not the originator of the securitised assets, the institution may still have problems in the direct application of IRB methodologies. In particular, some internal PD models require historical performance data that the servicer

which has not originated the exposures may not have. If an institution purchases receivables in a non-securitisation factoring transaction, and becomes the servicer of the purchased receivables even though it is not the originator, it can use the IRB purchased receivables approach in accordance with the applicable conditions, but under the EBA's proposed rule for securitisation purchased receivables approach, the non-originating institution could not use the purchased receivables approach while acting as servicer. The final RTS should allow an institution that is the servicer, but not the originator, of the securitised assets to calculate PDs and LGDs using the purchased receivables approach where it does not have sufficient data to determine these inputs using standard IRB methods.

The RTS should confirm that, where an institution purchases receivables directly and recognises refundable purchase price discount as first loss protection under the securitisation framework, it may use the securitisation purchased receivables approach (including the provisions on risk quantification, proxy data and other provisions not included in the IRB purchased receivables approach) in accordance with the RTS. For this purpose, the references to "the SSPE" in Articles 4, 6 and 9 of the draft RTS should be read as referring to (or should be changed to refer to) the SSPE or the institution as applicable.

Q2: Should an exception be introduced for certain corporate exposures (e.g. large corporate exposures that the institution may rate using the corporate rating system it uses to rate corporate clients)? Should such exception be limited to the estimation of PD? If yes, what alternative would you propose for LGD estimation?

We understand the proposed exception to mean that, when a particular corporate obligor is within the exception and the institution can calculate PD for that obligor using its approved IRB model, even when the institution is otherwise permitted and required to apply the securitisation purchased receivables approach to the relevant pool of exposures, it will not use that approach to determine a new PD for that corporate obligor, but may use the same PD for that obligor as it would use in a non-securitisation context. This makes sense because an institution should not have to use one PD or method of calculating PD for a particular obligor under one approach and a different PD or method under the alternative approach. Such an exception for corporate exposures is appropriate especially for concentrated exposures in the context of trade receivables, SME and leasing pools. Our members believe that they should be allowed to continue applying their internal IRB rating models in these cases even while applying the securitisation purchased receivables approach to other obligor receivables in the pool.

We believe that this exception should apply at least to exposures to obligors exceeding a given level of concentration in the pool of securitised exposures, which should be the same level of concentration as used to indicate granularity under Article 6.3 of the RTS. In general, it would not be feasible in a revolving pool of corporate receivables to identify all the exposures to obligors for which the bank may have an internal rating (if only because a single widely-used identification number is not available for most corporates). The most practical approach is for the institution to identify all exposures to obligors exceeding a given concentration level, to look for the PDs estimated by the institution on exposures to those obligors, and, as to any obligor for which that PD is not available, to calculate that PD. In other words, the primary criterion for use of the exception is whether the aggregate exposure to that obligor exceeds a given concentration level and is therefore not eligible for the retail approach.

In addition, if a firm can apply its own PD model to a particular corporate name and identifies that corporate as an obligor in a pool of purchased receivables, whether or not the exposures to that obligor make up a large concentration, the firm should be allowed to treat that obligor as excepted from the securitisation purchased receivables approach and apply that PD model to its exposures to that obligor.

Some different considerations apply to the determination of LGD, which depends more on factors related to the nature of the obligor exposure, transaction structure and terms rather than characteristics of the obligor. We propose that several different methods could be available depending on conditions:

- If the institution has already determined an LGD for exposures like the excepted securitised exposures, and expects the servicer performance for the securitised exposures to be materially similar to the servicer performance for the portfolio as to which the institution has determined the LGD (which would normally be the case for corporate trade receivables), then the institution may apply that LGD to the excepted exposures.
- In other cases, the institution could set up a mapping between underlying securitised assets and LGD grids and use that mapping to attribute LGD parameters to the excepted exposures. In this way the determination of LGD for excepted corporate receivables in a purchased receivables pool would be consistent with the determination of LGD for other purchased receivables in the pool.
- As an alternative to either of the foregoing, the institution could choose to use the foundation level LGD. We note that the use of foundation level LGD for corporates is already allowed in Article 160(2)(a) and (b) of the CRR under the EL decomposition approach. In addition, for trade receivables, using the unsecured corporate foundation LGD is conservative, because a corporate obligor in financial distress may keep paying its trade receivables even when it defaults on financial obligations, in order to continue trading with key suppliers.

We propose that an institution should be able to use any of these methods, or a combination of them (for example, using the first alternative in relation to obligor groups for which the LGD has been determined, and one of the other methods in other cases), provided that the institution adopts and uses the methods in a consistent way. These solutions should also be available for exposures to which "slotting" methods apply.

Q3: Do you agree with the fact that, unlike traditional securitisations, synthetic securitisations cannot meet the general conditions set out in this article and in particular the requirements on indirect control and ownership of the securitised exposures by the institution calculating K_{IRB}?

First, we agree that the effect of the existing and proposed conditions for use of the securitisation purchased receivables approach (in particular those relating to control of the receivables and collections) means that this approach would not be available to an investor (credit protection provider) in a synthetic securitisation, even though that investor would not be the servicer of the securitised exposures.

Also for the originator of a synthetic securitisation, under this proposal, the securitisation purchased receivables approach generally will not apply, because the originator generally will be the servicer of the securitised exposures. By the same token, generally the originator and servicer should have the data required for application of internal models and so would not

need to use the securitisation purchased receivables approach. Exceptions will arise where an institution purchases receivables serviced by a third party and synthetically sells off or insures a tranche of the credit exposure. In this case, the institution (as a "limb (b) originator" and as the credit protection buyer) may be within the scope and able to meet the operating conditions for the securitisation purchased receivables approach, but the investor (and credit protection provider) would not meet the conditions.

In synthetic securitisations, credit institutions subject to the CRR most often act as originators, and also servicers, of the securitised assets, rather than as investors and credit protection providers. For that reason, the conditions that prevent an investor in a synthetic securitisation from applying the securitisation purchased receivables approach under the CRR should have limited practical effect. On the other hand, the rarity of credit institutions as investors in synthetic securitisations may be due in part to limited practical options for determining their capital requirements.

In principle, institutions that are third party investors, not acting as servicers of the securitised assets, should be able to apply the securitisation purchased receivables method in synthetic as well as traditional securitisations, provided that the required data are available and appropriate conditions are met. The proposed RTS already represents a move away from the existing purchased receivables methodology, as the assets in a traditional securitisation will be held by an SPE rather than by the institution directly. If a synthetic transaction can be structured to give investors (and credit protection providers) sufficient protection in the event of default by the servicer (and credit protection buyer), then use of the securitisation purchased receivables approach should be allowed. The proposed indirect control requirements for use of that approach are very strict, as based closely on the existing direct control requirements of Article 184 of the CRR, and even some traditional securitisations may not meet all the requirements (particularly where there is active management of the pool). Our members would welcome opportunities for further dialogue with the EBA on the operational conditions for the securitisation purchased receivables approach, the underlying concerns and ways of addressing them, and the possibility of eventually developing a version of the securitisation purchased receivables approach that could also be applied to synthetic securitisations.

Q4: Do you consider that a more detailed definition of proxy data is necessary? If yes, please provide a suitable definition.

The definition of proxy data is fine in concept, although it is very short and not detailed, and although the concepts of internal data, external data and pooled data are not specifically defined in the CRR. It is crucial, however, that the RTS give more detailed and clearer guidance on the use of proxy data. See our further comments on this under Question 6.

From the Consultation Paper's provisions on use of proxy data, our members find it hard to gauge the EBA's expectations. This lack of specificity could lead to the various national (and eurozone) competent authorities taking inconsistent views. Our members are also uncertain as to under what circumstances they would be permitted to use internal, external or pooled data, especially as institutions are not permitted to use shared models.

It is also crucial that the RTS give further details regarding the relationship of the securitisation purchased receivables approach with the EBA Guidelines on PD estimation, LGD estimation and the treatment of defaulted exposures (November 2017) (the **"PD-LGD Guidelines"**). If adherence to the PD-LGD Guidelines is considered a prerequisite for

development of tailor-made internal models for calculating K_{IRB} using the securitisation purchased receivables approach, we expect that there will be too many constraints, given the relatively limited available data on securitisation and all the numerous detailed requirements that proxy data would have to meet. We therefore urge the EBA to provide in the RTS that adherence to the PD-LGD Guidelines will not be a prerequisite for the securitisation purchased receivables approach. In general we believe that the PD-LGD Guidelines are not designed for or well suited for application to purchased receivables portfolios, and we ask that the EBA consider supplementing the PD-LGD Guidelines to adapt them for purchased receivables including the securitisation purchased receivables approach. We also request specific guidance on the use of proxy data for obligor concentrations, where an institution has less information that on its own-originated positions.

Also, in relation to the use of proxy data, we ask that the EBA explain its views on different types of proxy data and their relationship to margins of conservatism. In particular, from an operative modelling perspective, we think that data obtained from specialised data warehouses (such as the European Data Warehouse) will necessarily be a primary type of data for institutions to use in developing top down models. In addition, such data should be seen as largely representative and relevant for the purpose of developing inputs to be applied to receivables originated and serviced by parties other than the institution. On the other hand, data directly related to the portfolio of securitised exposures in which the bank is investing may be much more limited in number of exposures, number of historical data points. We are concerned that data sourced from specialised warehouses, by being treated as "proxy" data and subject to margins of conservatism, may result in unduly high risk estimations, which would limit and discourage the use of this resource. We believe that any margins of conservatism applied in relation to such data should be relatively low, reflecting the breadth, depth and reliability of this data source.

Q5: Do you consider that the provisions set out in the draft RTS are workable if applied to securitisations of non-performing exposures?

Our members have a range of observations on this question:

To the extent that NPL transactions meet the definition of securitisation, the methods set out in the RTS should be workable, although obviously calculating PDs would not be necessary. Institutions should find it possible to calculate LGDs, particularly where relevant data such as third party valuations are available. NPL recoveries are frequently driven by commercial real estate and residential property markets, for which through-the-cycle data are frequently available and can enable investors to accurately predict the quantum of recoveries. Timing is another factor, and this is dependent on the servicers' individual experience as well as the foreclosure data available from specific jurisdictions. Timing would need to be used to assign a present value to recoveries in ascertaining LGD.

On the other hand, EL_{BE} and LGD in default, the main components for risk-weighting non-performing exposures, have a completely different background from that of the purchased receivables approach, which implies a performing expected loss estimate.

For NPL pools, the main issue is that both the SEC-IRBA and the SEC-SA result in extremely high risk weights for the senior tranches, so it makes these approaches uneconomic for bank investors. There is a need for a simple fix by introducing a cap on the risk weight of the senior tranche that takes into account the purchase price discount.

A particular issue arises under Article 4(2) of the draft RTS, which requires that the institution, among other things, "assesses the correlation among the quality of the securitised exposures and the financial condition of both the originator and servicer". It is important to clarify that the institution is not required to assess correlation between different securitised exposures in the portfolio, which would be especially challenging in relation to NPL portfolios. In any event, because in an NPL securitisation the focus is on recovery rather than on performance of the exposure, correlation of credit quality, whether between different obligors or between the obligors and the originator, is not relevant. In relation to NPL portfolios, this requirement should be dis-applied, or else modified to refer only to correlation between recoveries and credit risk of the servicer.

Q6: Do you have any other comments on the draft RTS?

We set out below a number of additional comments and questions together with our proposals to address these points:

Scope of validation of the securitisation purchased receivables approach

Issues:

- Uncertainty relating to the permission process, especially the requirement for an institution to obtain supervisory approval before using the securitisation purchased receivables approach: As noted in point 2 of the of the "Background and rationale" section of the Consultation Paper (at page 7), "Whereas the current securitisation framework provides that a specific supervisory permission is needed for institutions other than originators to use the IRB formulae-based approach to securitisation capital …, the Regulation amending CRR removes that specific approval and makes the use of SEC-IRBA only conditional on the IRB permissions of the credit risk framework and on the availability of sufficient information to compute K_{IRB}." On the other hand, with respect to the securitisation purchased receivables approach, points 17 and 18 (page 12) say that a permission for a tailor-made rating system is required and that any change to the internal model for calculating K_{IRB} should be assessed in accordance with the already existing CRR provisions on model changes. If such prior approval is required, implementation of the securitisation purchased receivables approach will be substantially delayed, and timing and scope of regulatory permissions may differ substantially between member states.
- Within a regulated banking group, there can be important differences in scope of IRB methodologies validated for different entities, such as a corporate and investment bank (CIB), and these differences may affect the CIB's eligibility to develop and use the securitisation purchased receivables approach.

Proposals:

- Provide in Article 2 that an institution already having an approved IRB model for the same asset class may apply the securitisation purchased receivables approach for that asset class following notification to the relevant competent authority without having to obtain the competent authority's prior approval. For this purpose an "asset class" could be one of the broad classes referred to in the EBA's final draft regulatory technical standards on homogeneity in the criteria for simple, transparent and

standardised (STS) securitisations (the **"Homogeneity RTS"**).[1] If the EBA's view is that it the procedure must include supervisory approval, some form of expedited approval process should be provided.

- Also for this purpose, and for purposes of the prior experience requirement in Article 3 of the draft RTS, the range of permissions obtained by the institution should include all those validated by entities within the group subject to consolidated supervision under the CRR. For example, where the group includes both a retail bank and a corporate bank or has credit institutions established in different member states, in relation to approval requirements for the securitisation purchased receivables approach, an IRB permission obtained by any of those entities could be relied on by other entities in the group.
- We wish to confirm our understanding of the reference in Article 3 to ' permission to apply the IRB approach for at least one rating system within the exposure class to which the securitised exposures are assigned'. For example, if a bank (or a bank group) has an AIRB model permission used for UK residential mortgages (because that is all the bank originates), we understand that will be enough for the bank to apply for permission to use the securitisation purchased receivables approach for any retail exposures, including residential mortgages in any jurisdiction.
- Institutions will not be able to develop models, prepare applications and obtain approvals to use the securitisation purchased receivables approach before the revised securitisation framework becomes applicable on 1 January 2019, and some institutions may not be able to obtain those approvals before the end of 2019. We therefore ask the EBA to consider and provide guidance on how institutions should calculate their capital requirements for securitisations where they are not originators or sponsors during the period after the revised framework become applicable and before they are able to obtain those approvals.

General conditions on risk quantification, credit policy and due diligence

Issue:

Article 4(a)(i) of the draft RTS requires "that the institution assesses the correlation among the quality of the securitised exposures and the financial condition of both the originator and servicer … ". Although the same wording appears in Article 184(3)(a) of the CRR under the IRB purchased receivables approach, it is confusing because the first part by itself suggests the institution must assess correlation "among" the securitised exposures in the portfolio. We believe this Article is intended and should be read to refer to correlation "between" the quality of the securitised exposures (on the one hand) and the financial condition of the originator and the servicer (on the other hand). Simply changing "among" to "between" would make this clearer.

Proposal:

In Article 4(a)(i) change "among" to "between" to make clearer that the correlation to be assessed is between obligor credit qualify (on the one hand) and seller and servicer financial condition (on the other hand) and not between different exposures in the portfolio.

[1] EBA Final Draft Regulatory Technical Standards On the homogeneity of the underlying exposures in securitisation under Articles 20(14) and 24(21) of Regulation (EU) No 2017/2402 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation (31 July 2018).

General conditions for risk differentiation

Issue:

- Article 5 requires institutions to differentiate between transactions based on the originator's underwriting standards and the servicer's recovery practices and servicing standards. To calibrate such differentiation would appear to require a historical data series of scores of some type, representing the quality of underwriting and servicing processes in place. Our members question whether such data will generally be available. Although all prudent institutions include a close qualitative evaluation of underwriting and servicing standards in their credit assessment approaches, we understand that the prevailing practice is to establish a minimum high standard of rigour which underwriters and servicers are expected to observe, and to have no risk appetite for transactions where adequate processes are not in place. Therefore, although assessment of these matters will generally form a key part of risk management, it will typically be difficult to differentiate, as all items in the data set will implicitly have the same high score.
- Article 5 of the draft RTS provides: "When assigning exposures to grades or pools, institutions shall consider the originator's underwriting standards and the servicer's recovery practices and servicing standards as risk drivers, unless they use different calibration segments for different originators and different servicers in quantifying the risk parameters associated with those grades or pools." Originator and servicer drivers should be considered important for retail portfolios, but for corporate and other non-retail receivables the credit quality of the individual obligors is a more important risk driver and the underwriting and servicing standards are relatively less important.
- Since one of the main purposes of the "top-down" approach for securitization is to apply easier methods given the lack of information, risk drivers falling under this category should be further specified, envisaging a minimum list, in order to avoid potential inconsistent application of the regulation as well as potential inconsistent assessment by the different national competent authorities. A possible approach might be to build on the Homogeneity RTS. In that context, the mapping of risk factors and asset categories envisages the creation of homogeneous clusters, allowing for the adoption of a simple top-down approach and leading to proper consistency and synergies with other regulatory products related to the new securitization framework.

Proposal:

- Consider modifying this condition to require institutions to apply a minimum standard of originator and servicer underwriting standards and recovery practices, rather than treating them as risk drivers to differentiate between transactions.
- Add flexibility to consider originator and servicer risk drivers where relevant and appropriate: After "servicing standards as risk drivers", add "(in the case of non-retail exposures, if and to the extent relevant and appropriate)".
- Where originator and servicer risk drivers apply, clarify parameters to foster consistent treatment, using the matrix of risk factors and asset categories established in the Homogeneity RTS.

Granularity requirement:

Issues:

- For purposes of determining whether a pool of securitised exposures is "sufficiently granular" to support the use of retail quantification standards with respect to non-retail securitised exposures (Article 6(3)(d)), the Consultation Paper proposes that the aggregate exposure to a single obligor should be no more than 2%. A benchmark of 2% in this context would cause problems in particular for securitisations of corporate exposures such as trade receivables, auto dealer floorplan receivables or equipment leases, where the pool of securitised exposures may include larger aggregate exposures to obligors, including obligors on which institutions may not have enough information to calculate IRB parameters. It would also be inconsistent with global market practice (and so put European banks at a disadvantage), which allows higher unrated obligor concentrations provided that first loss reserves are set accordingly.
- The proposed 2% concentration limit is not consistent with the granularity threshold of $N \geq 25$ (where N is the effective number of exposures), implying a maximum obligor concentration of 4%, provided in Article 259 (points 1 and 4) of the CRR (as amended by the CRR Amending Regulation) for purposes of calculating risk weighted exposure amounts under the SEC-IRBA. (Point 6 of Article 259 specifies a 3% limit for use of a simplified method to calculate N and exposure-weighted LGDs, but that limit relates to single exposures rather than aggregate exposure to an obligor.) We believe that the largest obligor concentration in this context should be stated as 4%, consistent with the granularity standard in amended CRR Article 259. In all cases, institutions will have to provide adequate conservatism in their calculations, taking into account relevant factors including pool granularity.
- Decreasing the concentration threshold even from 3% to 2% could represent an increase of about 50% in concentrated names for certain trade receivables transactions. This would make the securitisation purchased receivables approach more burdensome and costly to use.
- We note as well that in ABCP transactions, as well as other bank-funded revolving securitisation transactions, it is not always realistic to track all connected clients, given the granularity and revolving nature of the pools. This is already taken into account in Article 243(b) of the amended CRR, which says that "for the purpose of this calculation, loans or leases to a group of connected clients, *to the best knowledge of the sponsor*, shall be considered as exposures to a single obligor" (italics added). Similarly, the final RTS should provide for obligor concentration limits on obligors to be calculated on groups of connected clients "to the best knowledge" of the purchasing institution or, in the case of an ABCP transaction, the sponsor of the ABCP program.
- We understand that the maximum obligor concentration percentage is not proposed as a strict requirement but as an indicator that "the pool of securitised exposures is sufficiently granular" to support a determination that requiring use of risk quantification criteria for corporate exposures would be "unduly burdensome" and use of retail quantification criteria is justified. However, the final text should also make clear that a larger concentration would not prevent the pool from being "sufficiently granular" where that concentration falls within the exception referred to in Question 2. In that case, the institution would determine the capital requirement for the relevant obligor exposures using its regular IRB model (or, if applicable in a mixed pool, the

standardised approach), while still being able to apply the securitisation purchased receivables approach to the remaining granular exposures.

- Again for purposes of determining whether a pool is "sufficiently granular" for use of retail risk quantification standards, the Consultation Paper proposes a minimum number of 500 exposures in the pool of securitised exposures. We think that this requirement would be much too restrictive for a number of reasons, including the following:
  - From a mathematical perspective, as shown in Duponcheele et al., "Granularity, Heterogeneity and Securitisation Capital" (2013),[2] granularity is a significant risk driver only when the effective number of assets is below 100.
  - From a practical perspective, as the number of obligors may be as high or nearly as high as the number of exposures, a line-by-line analysis of each obligor name (as would be required if the securitisation purchased receivables approach and retail quantification standards could not be used) is both time-consuming and costly. Assuming for example, that in order to derive a PD/LGD on a single name, a minimum of three hours are required (which we believe is a very low estimate – for corporate exposures it can be up to two working days), then for a pool of 500 exposures (assuming up to 500 different obligors), this would represent at least 1500 hours or more than 150 man-days. Given that regulatory parameters have to be updated quarterly and require ongoing control and monitoring, their calculation would require more than two full-time employees even for a single transaction, which would clearly be unduly cumbersome and costly. Even with investment of time and cost, for purchased exposures to private corporate obligors, often the institution will not have sufficient information to perform an individual risk rating. Institutions need to be able to apply retail risk quantification standards even for a much lower number of pool exposures.
  - The proposed requirement of at least 500 exposures would exclude many securitisations of non-retail exposures, including many trade receivables purchase facilities and collateralised loan obligations (CLOs), from the use of retail risk quantification standards in the securitisation purchased receivables approach.

  We believe that, as a benchmark for granularity in application of the securitisation purchased receivables approach, in addition to a 4% concentration limit, the RTS should adopt the granularity standard of $N \geq 25$ from Article 259 as referred to above.

Proposals:

- The obligor concentration limit indicating a "sufficiently granular" pool in Section 6(3)(d) should be 4% rather than 2%.
- In the same context, rather than requiring a minimum number of securitised exposures, require an effective number of exposures 'N' of at least 25, consistent with the granularity standard in Article 259 of the amended CRR.
- Apply the granularity requirement to the pool used to seek approval for the use of the securitisation purchased receivables approach but not to each transaction where the approach is to be applied.

[2] Available at http://www.riskcontrollimited.com/public/Granularity_Heterogeneity_and_Securitisation_Capital.pdf.

Calculation of concentration limit:

Issues:

- For trade receivables pools, often the transaction is structured so that the seller transfers all its receivables to the SPE but only the eligible ones are counted in determining the maximum amount of funding by the investors, so concentrations could be overstated if based on total pool versus funded pool.
- For financial receivables, using a "borrowing base" concept, receivables that become ineligible for funding, including the portion of an obligor's receivables that exceed applicable obligor concentration limits, stay in the pool but are no longer eligible for funding, so again concentration could be overstated if based on the total pool and not the funded pool.
- Similar concerns arise in other contexts under the CRR and the Securitisation Regulation, including the calculation of the W factor under the SEC-SA (Article 260 CRR), the STS 2% concentration limit and the STS exclusion of exposures from credit-impaired obligors, and we have raised these concerns in our comments on the EBA's proposed guidelines on the STS criteria.[3] The additional criteria for STS treatment under the CRR address this concern in relation to trade receivables in ABCP securitisations by providing that "only the portion of the trade receivables remaining after taking into account the effect of any purchase price discount and overcollateralisation shall be used to determine whether they are fully covered and whether the concentration limit is met" (Article 243(1) CRR). The EBA should apply the same concept to this granularity requirement for retail quantification standards under the securitisation purchased receivables approach.
- The RTS need to take into account the practicalities of making calculations on short-term receivables pools with high turnover and for which information is reported periodically (generally on monthly basis).

Proposals:

- Specify for purposes of Article 6(3)(d) that concentrations are calculated based on the funded pool only, excluding receivables (and excess obligor concentrations) in the pool that are ineligible for funding.
- Where exposures to a single obligor (or a group of connected clients) exceeds the specified concentration limit, that should not prevent the institution from applying the securitisation purchased receivables approach or retail quantification standards to the pool as a whole, but only to the relevant obligor (or group). In an appropriate case (and to the extent the excess concentration is required to be included in the calculation of K_{IRB}), the PD and LGD for that obligor (or group) can be dealt with under the proposed exception for certain corporate obligors referred to under Question 2.
- Allow calculations to be done on the basis of, and with frequency consistent with, periodic reports provided by the servicer (for example, on a monthly basis for ABCP transactions).

[3] Available at http://www.eba.europa.eu/documents/ddm/com.liferay.portlet.dynamicdatalists.model.DDLRecord/2282891/ddm-fileupload36031

Standards for eligibility for retail treatment – non retail vs. retail

Issue:

Article 6(2)(a) includes a requirement (as a condition for application of retail quantification standards to non-retail exposures) that "the SSPE shall have purchased the securitised exposures from unrelated third party originators to the institution calculating K_{IRB}, and its exposure to the obligors in the pool of securitised exposures shall not include any exposures that are directly or indirectly originated by the institution calculating K_{IRB} itself". Article 7 (the corresponding provision for retail exposures) does not include that requirement. The explanation given in paragraph 20 of the "Background and rationale" section of the Consultation Paper is that "If that point were applied [to retail exposures], an originator that does not service the exposures underlying the securitisation would be precluded from treating under retail risk quantification standards the securitised exposures that itself has originated and classified as retail exposures in accordance with the credit risk framework of the CRR." Apparently, the point is that an institution has to be able to apply retail risk quantification standards to retail exposures, even if it originated those exposures itself, but it does not have to be able to apply retail risk quantification standards to non-retail exposures. Another reason for the difference might be that it would be less practical for institutions to ascertain compliance with this requirement in relation to retail than in relation to non-retail portfolios. However, applying the requirement to non-retail portfolios means that "an originator that does not service the exposures underlying the securitisation would be precluded from treating under retail risk quantification standards the securitised exposures that itself has originated". While we are not arguing to apply the requirement also to retail receivables, we would like the EBA to please clarify the explanation for the difference in treatment.

Proposal:

- Clarify rationale for requirement of no own-originated exposures as condition to use of retail risk quantification standards for non-retail exposures but not for retail exposures.

Default definition requirements:

Issues:

- Where the seller or servicer reports obligor defaults based on a 90 days past due definition consistent with the CRR standard, institutions can use that data without having to perform complex reconciliation and then add a margin of conservatism. However, in third party securitisations by non-banks, it is usually more difficult.
- For purchased receivables, the data available from the clients is often not in line with the 90 days default definition and the issue is how to make adjustments to achieve broad equivalence.
- Other points of the new EBA default definition will often not be followed by corporate or sellers when recording or reporting defaults. This is the case of materiality thresholds, technical defaults guidelines, distressed restructurings and probation period for return to non-default.
- The techniques deployed by European banks to assess the impact of the new default definition for their originated pools cannot realistically be implemented by sellers in the context of purchased receivables. It will therefore be challenging to assess the margin of conservatism necessary to achieve broad equivalence to compliant data.

- Institutions' default definitions are likely to be based in part on qualitative factors which may differ between institutions.

Proposals:

- Develop guidelines on achieving equivalence to default and LGD rates calculated according to a fully compliant default definition.
- Maintain more objective definition of default to cover days past due and triggers applied by servicers (rather than subjective standards of whether the obligor is unlikely to pay) to allow for more comparability and consistency of application between different institutions.

<u>Estimating PD/LGD based on static vintage data</u>:

Issue:

- There is no mention in the regulation on how to use static performance data to derive regulatory compliant PD/LGD under the securitisation purchased receivables approach.

Proposal:

- Clarify that institutions are allowed to estimate PD/LGD from static data and in particular:
    - Extrapolate recent vintages based on the weighted average performance of older vintages.
    - Derive annual pool pd from static data using an annualisation formula.
    - Derive LGD by dividing gross default by net default.
    - Use well-established industry practises to derive a margin of conservatism estimation based on vintage performance variability. This would include deriving gross loss data from net loss data.
    - Gross-up of PD based on default definition other than 90+ using roll rate data/benchmarks to estimate 90+ PD.

<u>Estimating PD/LGD based on dynamic default data</u>:

Issue:

- There is no mention in the regulation on how to use dynamic performance data to derive regulatory compliant PD/LGD under the securitisation purchased receivables approach.

Proposal:

- Clarify that institutions are allowed to estimate pool PD from dynamic default data, including acceptable estimations/benchmarks for cure rate.
- Clarify that institutions are allowed to estimate pool LGD from dynamic data, and provide guidance on how to adjust for downturn effects, time discounting of recovery period, inclusion of recovery costs and adjustments for default definition other than 90+.

Expected loss (EL) approach:

Issue:

- Article 160(2) CRR shows two options on the EL approach:
  - Option 1: PD = EL / LGD with LGD = foundation level (Article 160(2)(a),(b) CRR)
  - Option 2: PD = EL/LGD with internal LGD assessed in a "reliable manner" (Article 160(2)(c) CRR)

Proposal:

- Clarify under which conditions and in which contexts banks could use Article 160(2) CRR.
- Clarify the minimum requirement for LGD assessment under Article 160(2)(c) CRR and the meaning of the ability to decompose the EL, since the EL and LGD would be known.
- Clarify criteria to fall back on EL decomposition method.
- Clarify criteria to estimate margin of conservatism for the decomposition approach.

Downturn LGD

Issue:

- The EBA's proposed RTS and guidelines on estimation and identification of economic downturn in IRB modelling[4] have been designed more for on-balance sheet exposures and not for purchased receivables exposures.

Proposal:

- Clarify how those proposed RTS and guidelines apply in the context of purchased receivables and in particular for estimation of the downturn LGD.

Margin of conservatism:

Issues:

- PD-LGD Guidelines on default definition under Article 178 CRR: for external data, in case broad equivalence cannot be achieved, flexibility to add a margin of conservatism related to the range of estimation errors (Article 179(1)(f) CRR).
- Flexibility to incorporate a margin of conservatism in the risk parameters is welcome, but the issue becomes how to demonstrate that the margin of conservatism covers estimation errors and data limitations, especially data limitations which are more prevalent for purchased receivables. In particular, we refer to our comment on the default definition, and to the difficulty of sizing the difference between received data and fully compliant data, which are not known.

[4] EBA Consultation Paper On Guidelines for the estimation of LGD appropriate for an economic downturn ('Downturn LGD estimation') (22 May 2018); EBA Consultation Paper; Draft Regulatory Technical Standards on the specification of the nature, severity and duration of an economic downturn in accordance with Articles 181(3)(a) and 182(4)(a) of Regulation (EU) No 575/2013 (22 May 2018).

Proposal:

- Develop guidelines on appropriate range of the margin of conservatism, taking into account data limitations for PD and LGD estimation, especially for limitations inherent to purchased receivables, such as default definition, aggregated data or shorter data horizon.

Dilution risk:

Issues:

Referring to Articles 163(3) and 164(1) CRR on PD and LGD for dilution risk:

- CRR makes the assumption that, as a first step, there is no recourse to the seller for dilution risk (recourse to the seller can only be considered as a risk mitigant).
- Dilution is a reduction of the value of a receivable, that is, a pure loss. In the absence of recourse to the seller, the LGD would therefore be 100%, not 75%. Furthermore, dilution is unrelated to credit risk of the obligor and may be unrelated to credit risk of the seller (e.g., error on invoice or mistake in delivery of goods).
- It is therefore difficult to articulate the dilution rate, PD of the seller and LGD of the seller within the requirements of Articles 163(3) and 164(1) CRR.

Proposal:

- Please confirm that, for institutions using the Advanced IRB approach, corporate sellers providing recourse for dilution (and for which the institution has internal PD and LGD) shall be treated as eligible unfunded credit protection providers without a floor rating. This approach is consistent with Article 201(1) of the CRR and the Advanced IRB approach under the Basel framework, and, in each case, is the only approach which provides recognizable results for trade receivable transactions.
- Provide guidance on compliant representation of dilution rate and recourse to the seller.

Other non-credit risks:

Issues:

- Another issue arises in relation to pools that include non-credit obligations, such as residual value risk in lease securitisations. The question is how to determine the *p* value in the SEC-IRBA formula for the non-credit obligation part of the pool. For non-credit exposures, there is by definition no PD or LGD, but one of the factors in calculating p is the LGD. This is a general issue in the SEC-IRBA but is particularly relevant for the securitisation purchased receivables approach.

Proposal:

- A potential solution to this issue is the one mentioned above in our general comments, that is, to use the 50% LGD referred to in Article 259 of the amended CRR. This solution should also be applied for exposures to which slotting methods apply.

Information data and requirements:

Issues:

- Under Article 179(1)(e) CRR, estimates shall reflect all relevant information available to the purchasing institution.
- The obligation under Article 179 CRR must be balanced against the principle of the purchased receivables approach and the "unduly burdensome" criterion under Article 153(6) CRR. For instance, for trade receivables with thousands of obligors it would be unduly burdensome to require the institutions to check the internal PD/LGD on all the names in the pool, especially in the case of short-term receivables with rapid turnover.

Proposal:

- Specify that the obligation under 179(1)(e) only applies to the extent it is not unduly burdensome.

Other points:

As noted in our response to Question 4, we think it is unclear whether institutions can use internal data as an input in models for third party data, as this seems contrary to eliminating the use of shared model for third-party pools.

In considering the use of external data for estimating IRB inputs, we note that there is a relative lack of readily available external data on UK transactions, which do not feed into the EDW.

While it is not within the scope of the Consultation Paper, we believe that the 5% limit for "mixed pool" treatment under the SEC-IRBA should be revisited and a higher limit such as 10% or 15% would be appropriate. This should be considered along with other issues when the EBA and Commission review the operation of the amended CRR.

4. Risk Control paper

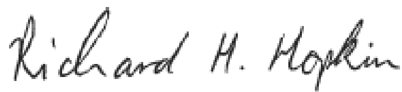
The EBA should also take into account the paper prepared by William Perraudin and others at Risk Control Limited dated on or about the date of this response and referring to the Consultation Paper. While we have not been directly involved in preparation of that paper or contributed to its content, we have supported and encouraged Risk Control's independent study of the Consultation Paper, analysis of available data and production of the Risk Control paper. We note in particular several observations and questions set out in the appendix to that paper, with which we agree and which we summarise as follows:

- The proposed data hierarchy favours the use of, first, data directly related to the relevant pool, second, external data similar to the relevant pool, and third, investor's internal data. This data hierarchy implies that the securitisation purchased receivables approach will be a statistical methodology that will have to be re-estimated frequently and adapted for different asset classes and transactions rather than a framework that only has to be recalibrated periodically. We request the EBA to explain its thinking on data hierarchy and its implications for the model.

- Proxy data may be of various types including loan-level data and aggregate data like those commonly found in securitisation reports (including the use of representative lines). We request the EBA to clarify its views on the different types of data and their relationship to margins of conservatism.
- The margins of conservatism referred to in PD-LGD Guidelines include three categories of adjustments (those being (A) identified data and methodological deficiencies, (B) changes to underwriting standards, risk appetite, collection and recovery policies, other sources of uncertainty, and (C) general estimation error), and these concepts could be applied to the securitisation purchased receivables approach. However, in this context, given the above points about data sources and having to adapt the method for different asset classes and transactions, applying these concepts is likely to be challenging and costly. We request the EBA to acknowledge these challenges and limit onerous supervisory expectations.

5. Conclusion

Again we thank the EBA for its constructive and thoughtful proposal on use of the purchased receivables approach in the securitisation framework. We hope that our observations and comments will help the EBA to further improve this aspect of the new securitisation framework. We will be happy to discuss these comments further with the EBA and its securitisation working group in order to support their efforts to complete and finalise the RTS.



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