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Joint Associations' Response to CP2/26 and CP26/6 – Follow-up paper on STS asset risk weights and fallback investor risk weights

Further to our joint associations' response to CP2/26 and CP26/6, in which we indicated that we would provide the PRA, under separate cover, with further technical considerations regarding the fallback investor risk weights provided for in PRA PS13/24 and their interaction with the STS asset risk weights in revised Article 243(2)(b) of the Securitisation Part, AFME submits this paper setting out those considerations.

1. **In relation to non-SME unrated corporate exposures, the same asset can qualify, or not qualify, as STS for prudential purposes depending on the prudential approach, within the SA, applied by the bank making the determination. Originators and sponsors are often required to warrant, and STS verification agents to verify, eligibility for STS prudential benefits. This is problematic absent an objective standard applicable to at least all UK bank investors. Objective eligibility for STS prudential benefits, at least for all UK bank investors, is also important from a liquidity perspective. Eligibility or otherwise of non-SME unrated corporate exposures for STS prudential benefits should be determined on the basis of the non-risk sensitive approach to non-SME unrated corporate exposures (IG/non-IG status would continue to be reflected in KSA and the capital requirements of the securitisation position save in the case of a non-originator bank lacking data and relying on the Conservative Securitisation Investor Fall-Back Risk Weights for risk weighting purposes).**

   Article 243(2)(b)(iv) of the Securitisation Part of the PRA Rulebook sets the maximum risk weight for "other exposures" (i.e. exposures not falling within the categories specified in

Article 243(2)(b)(i) through (iii)) to be eligible for STS. "Other exposures" would include non-SME unrated corporate exposures, and the risk weight specified is 100% on an individual exposure basis. Where a bank elects to apply the PRA's preferential risk sensitive approach to non-SME unrated corporate exposures (which it must do on an institutional basis rather than on a per transaction basis), the risk weight for an investment grade non-SME unrated corporate exposure is 65%, while the risk weight of a non-investment grade non-SME unrated corporate exposure is 135%.

Where a bank elects not to apply the PRA's preferential risk sensitive approach to non-SME unrated corporate exposures (which it must do on an institutional basis rather than on a per transaction basis), the risk weight of all non-SME unrated corporate exposures (investment grade and non-investment grade) is 100%.

The PRA has helpfully provided conservative fall-back risk weights, under Article 255(10)(b) and (c) of the Securitisation Part of the PRA Rulebook, for securitisation investors (but not originators) that lack the requisite data to calculate SA risk weights in respect of securitised assets (the **Conservative Securitisation Investor Fall-Back Risk Weights**). It appears, from the cross-reference, in Article 243(2)(b), to Article 255(10) "where relevant and applicable", that the Conservative Securitisation Investor Fall-Back Risk Weights are intended to be available for purposes of calculation of the STS maximum asset risk weights, though, it would be helpful if the PRA could confirm that this is the intention.

Where an investing bank (irrespective of its institutional approach to directly held non-SME unrated corporate exposures) applies the Conservative Securitisation Investor Fall-Back Risk Weights for purposes of the maximum STS asset risk weights in Article 243(2)(b)(iv), the applicable risk weight for all non-SME unrated corporate exposures (investment grade and non-investment grade) is, also, 100%.

The same non-investment grade non-SME unrated corporate exposure can therefore qualify, or not qualify, as STS for prudential purposes depending on the prudential approach applied by the bank making the determination. Article 243(2)(b)(iv) does not explicitly specify from whose perspective the assessment is made (either in relation to asset weight or the eligibility of any associated credit risk mitigation[1]). Unless otherwise specified, however, determinations required under the PRA Rulebook as it applies to CRR firms are generally those of the bank determining its prudential requirements.

Originators and sponsors are often required to warrant, and STS verification agents required to verify, eligibility for STS prudential purposes. This is not possible, absent an objective standard applicable to at least all UK bank investors. The creation of an objective standard, was presumably the intention of the CRR legislators in requiring risk weights to be determined using the SA (eligibility, once achieved, was also made immutable by testing the risk weight requirements only at the point of contribution of an asset to the securitisation rather than as an ongoing requirement which would have given rise to prudential instability). The objectivity of eligibility for STS prudential benefits, at least for UK bank investors, is also important from a liquidity perspective. The subjective, institution-specific nature of the assessment made in respect of non-SME unrated corporates undermines this objectivity and

[1] Which must be "direct" from the perspective of the determining bank, though we believe there to be good arguments, in relation to the calculation of KSA, that CRM eligible in the hands of the originator, the benefit of which is transferred to the SSPE, should be recognisable, and will be happy to discuss these arguments bilaterally.

is problematic. Eligibility or otherwise of non-SME unrated corporate exposures for STS prudential benefits should be determined on the basis of the non-risk sensitive approach to non-SME unrated corporate exposures. IG/non-IG status would continue to be reflected in KSA and the capital requirements of the securitisation position save in the case of a non-originator bank lacking data and relying on the Conservative Securitisation Investor Fall-Back Risk Weights for securitisation risk weighting purposes.

2. **We note that the STS maximum asset risk weights continue to exclude project finance portfolios that include any single exposure in the pre-operational phase. The absence of STS prudential benefits will affect banks' incentives to undertake securitisations of this asset class which is important to the real economy and, in particular, green transition and digital transformation. We assume that this outcome reflects the PRA's intention.**

   Article 243(2)(b)(iv) of the Securitisation Part of the PRA Rulebook sets the maximum risk weight for "other exposures" (i.e. exposures not falling within the categories specified in Article 243(2)(b)(i) through (iii)) to be eligible for STS. "Other exposures" would include project finance exposures, and the risk weight specified is 100% on an individual exposure basis. Pre-operational project finance attracts a 130% risk weight under Article 122B(2)(c) of the Credit Risk Standardised Approach (CRR) Part of the PRA Rulebook and so is incompatible with the specified risk weight limits. The applicable risk weight limit applies on an individual exposure basis, meaning that a single pre-operational exposure in a pool would result in non-compliance with the STS risk weight limits. The absence of STS prudential benefits will affect banks' incentives to undertake securitisations of this asset class which is important to the real economy and, in particular, green transition and digital transformation.

3. **It is impossible (both under the standard SA risk weights and under the Conservative Securitisation Investor Fall-Back Risk Weights, assuming that these are intended to be available for purposes of calculation of the STS maximum asset risk weights) for non-regulatory RRE to comply with the 50% maximum risk weight specified for this asset class for STS prudential purposes. Attainable risk-weights should be specified.**

   Article 243(2)(b)(ii) of the Securitisation Part of the PRA Rulebook specifies the maximum risk weight, under the Standardised Approach to credit risk (**SA**) for non-regulatory residential real estate (**RRE**) to be eligible for STS. The risk weight specified is 50% on an individual exposure basis.

   Under Article 124J(1) and (2) of the Credit Risk Standardised Approach (CRR) Part of the PRA Rulebook, however, the risk weight for non-regulatory RRE that is not materially dependent, for repayment, on the cash flows from the property (**non-MDCF**) is a look through to the risk weight of the counterparty, which, for a retail exposure that is not a revolving credit facility, is 75% (which is greater than 50%). The risk weight for non-regulatory RRE that ***is*** materially dependent, for repayment, on the cash flows from the property (**MDCF**) is 150% (again greater than 50%).

   As indicated above, it appears, from the cross-reference, in Article 243(2)(b), to Article 255(10) "where relevant and applicable", that the Conservative Securitisation Investor Fall-Back Risk Weights are intended to be available for purposes of calculation of the STS maximum asset risk weights, though, it would be helpful if the PRA could confirm that this is the intention. Under the Conservative Securitisation Investor Fall-Back Risk Weights, however, the risk weight applicable to non-regulatory RRE that is not-MDCF is 100%, while the risk weight applicable to non-regulatory RRE that is MDCF is 150% (again, both greater than 50%).

It is therefore impossible under both the standard SA risk weights, and the Conservative Securitisation Investor Fall-Back Risk Weights, for non-regulatory RRE to comply with the maximum risk weight specified for STS prudential purposes (absent some form of additional credit risk mitigation).

4. **The Conservative Securitisation Investor Fall-Back Risk Weight for RRE exposures that are non-MDCF is significantly higher than the SA risk weight applicable to such exposures where the counterparty is a natural person (i.e. standard direct to consumer mortgages), so Article 255(10)(b) will not be used.**

Article 255(10)(b) applies a Conservative Securitisation Investor Fall-Back Risk Weight of 100% to RRE exposures that are non-MDCF. This risk-weight is, however, significantly higher than the SA risk weight applicable to such exposures, where the counterparty is a natural person (i.e. standard direct to consumer mortgages) or SME, even if the investor bank is obliged, due to lack of data, to assume that they the exposure is not regulatory RRE. Under the SA, such exposures would either be classified as regulatory and risk weighted at 20% up to a 55% LTV and at the counterparty risk weight - 75% for a natural person – for any excess (under Articles 124F and 124L), or classified as non-regulatory and risk-weighted at the risk weight of the counterparty -75% for a natural person (under Articles 124J and 124L). The Conservative Securitisation Investor Fall-Back Risk Weight of 100% could only be approached if the counterparty to the RRE exposure was neither a natural person (counterparty risk weight deemed 75% under Article 124L) nor an SME (counter-party risk weight deemed 75% if retail, 85% is non-retail under Article 124L).

As indicated below, however, a bank acting as investor (rather than originator) in a securitisation of RRE is likely, in practice, to be forced to assume that any underlying RRE exposure is MDCF and to apply a 150% risk weight under Article 124J or 255(10)(c).

5. **Due to inability to diligence the three-property limit forming part of the boundary between non-MDCF and MDCF RRE (which also applies under the Conservative Securitisation Investor Fall-Back Risk Weights), a bank acting as investor (rather than originator) in a securitisation of RRE is likely, in practice, to be forced (for securitisation position risk weighting purposes as well as for purposes of the STS maximum asset risk weights) to assume that the underlying RRE is MDCF. If, as is likely in practice, the non-originator investor is also unable to confirm compliance with the detailed requirements for regulatory RRE, this will mean applying a 150% risk weight to all securitised RRE (in which circumstances, the fall-back risk weight under the Conservative Securitisation Investor Fall-Back Risk Weights is identical to the SA risk weight for non-regulatory MDCF RRE so will not be used). Applying a 150% risk weight to all securitised RRE does not appear an appropriate or risk aligned outcome and is likely to deter non-originator bank investment in securitisations of RRE (due to both the risk weighting of the resulting securitisation positions and, from the investor bank's subjective perspective, their ineligibility for STS prudential benefits).**

The definition of MDCF in relation to RRE in Article 124E of the Credit Risk Standardised Approach (CRR) Part of the PRA Rulebook will contain an exemption for exposures to individual landlords with three or fewer mortgaged properties (excluding their primary residence) with any lender. The Conservative Securitisation Investor Fall-Back Risk Weights also distinguish between non-MDCF and MDCF RRE. In order to confirm whether an exposure to an individual borrower falls within this exemption, which applies to both regulatory RRE and 'other' RRE, it is necessary to know the name of the individual borrower. This information is not provided for in the UK templates. A bank investing in a securitisation that is not the originator of the securitisation will therefore have to assume that the exposure ***is*** MDCF. Exposures are assumed to be MDCF unless otherwise positively determined under Article 124E.

Qualification as regulatory RRE entails compliance with a large number of highly granular requirements under Article 124A, C and D. A bank acting as investor (rather than originator) in a securitisation of RRE is, in practice, therefore also likely be forced to assume that the RRE is non-regulatory.

A 150% risk weight applies to non-regulatory MDCF RRE under Article 124J(1). The fall-back risk weight under the Conservative Securitisation Investor Fall-Back Risk Weights in Article 255(10)(c) of the Securitisation Part of the PRA Rulebook, is identical to the SA risk weight for non-regulatory MDCF RRE so will not be used.

Under either risk weighting approach, a non-originator investor is likely to have to apply a 150% risk weight to all underlying securitised RRE.

This does not appear an appropriate or risk aligned outcome and is likely to deter non-originator bank investment in securitisations of RRE (due to both the risk weighting of the resulting securitisation positions and, from the investor bank's subjective perspective, their ineligibility for STS prudential benefits).

6. **In relation to third country securitisations in which a UK bank acts as investor (rather than originator), real estate exposures collateralising such securitisations qualifying as regulatory real estate under the local implementation of Basel will likely be required to be classified as other real estate by the UK bank investor, and real estate exposures collateralising such securitisations qualifying as non-MDCF under the local implementations of Basel will likely be required to be classified as MDCF by the UK bank investor, with, in consequence, high risk-weights disproportionate to their risk.**

The definition of regulatory real estate (cross referring to compliance with Article 124A) is UK specific. Real estate exposures qualifying as regulatory real estate under other local implementations of Basel - not originated and/or serviced in contemplation of the UK rules - will likely not qualify as regulatory real estate in the UK. An obvious, substantive, example of difference between the UK and EU would be the different valuation requirements applicable (e.g. different bases for diverging from origination valuation), though multiple points of detail would likely prevent compliance. Real estate exposures qualifying as regulatory real estate under other local implementations of Basel collateralising third country securitisations in which a UK bank acts as investor (rather than originator) will therefore likely be required to be classified as other real estate with high risk-weights disproportionate to their risk.

Similarly, the UK definition of MDCF differs from other local implementations of Basel. For example, the EU retains the 'hard test' override to MDCF classification for RRE and CRE (deleted in the UK implementation) and the scope of its RRE exemption for small landlords differs. Real estate exposures qualifying as non-MDCF under other local implementations of Basel collateralising third country securitisations in which a UK bank acts as investor (rather than originator) will therefore likely be required to be classified as MDCF with high risk-weights disproportionate to their risk.

7. **Even originator banks are unlikely to be able to confirm that "each exposure" in a highly granular RRE portfolio (including assets previously contributed to the securitisation) complies with the detailed eligibility requirements for regulatory RRE when tested post-closing in relation to replenishment/substitution/ramp-up assets, as required by the STS maximum asset risk weights for regulatory RRE. For example, ineligibility of certain assets (even just a single asset – individual exposure basis) could have resulted from failure to coordinate revaluation of those assets with the specified frequency. It is not clear whether the addition of the new assets, in these circumstances, would result in prudential STS failure for the deal (the newly contributed assets would likely not, themselves, be non-regulatory RRE eligible for testing under Article 243(2)(b)(ii)).**

8. **If the Conservative Securitisation Investor Fall-Back Risk Weights are intended to be available for purposes of calculation of the STS maximum asset risk weights, we note that the available risk weights (100% for non-MDC RRE, 150% for all other real estate exposures) do not facilitate prudential STS eligibility for any class of real estate (for which the STS maximum asset risk weights are 40% on a weighted average basis for portfolios where each exposure in the portfolio is regulatory RRE, 50% on an individual exposure basis for non-regulatory RRE and mixed real estate, and 60% on an individual exposure basis for CRE).**

9. **We note that the STS asset risk weight limits in relation to CRE exposures and ADC exposures (100% and 60% respectively, on an individual exposure basis) are the minimum possible risk weights for such exposures under the UK Basel 3.1 implementation and that the circumstances in which these risk weights are available are very restrictive (CRE can only achieve a 60% risk weight where it is: regulatory CRE, not materially dependent on cash flows from the property, and where the LTV is <= 55% or the counterparty risk weight also does not exceed 60%. ADC can only achieve a 100% risk weight where it takes the form of a loan granted for the purpose of developing residential real estate satisfying specified conditions). We assume that this is the PRA's intention.**

10. **It is not possible for a retail exposure to fail to qualify under the STS maximum asset risk weights.**

    A regulatory retail exposure will be assigned a 45% risk weight if to a transactor, or a 75% risk weight to a non-transactor (under Article 123(3)(a) or (b)). A non-regulatory retail exposure will be assigned a 100% risk weight (under Article 123(5)). The STS maximum asset risk weight for regulatory retail exposures is 75% (Article 243(2)(b)(iii)). Non-regulatory retail exposures will fall within the residual 100% STS maximum asset risk weight for "any other exposures" (under Article 243(2)(b)(iv)).

11. **Request for clarification that use of the Conservative Securitisation Investor Fall-Back Risk Weights for non-SME unrated corporate exposures requires the same approach to be taken to all exposures in the securitisation in question.**

    In relation to the Conservative Securitisation Investor Fall-Back Risk Weights for non-SME unrated corporate exposures, in Article 255, use of the fall-back is made conditional on "the institution replac[ing] the risk weight for all such underlying exposures in the same manner". It would be helpful if the PRA could confirm that the condition requires the same approach to be taken to all exposures in the securitisation in question, rather than to, for example, all non-SME unrated corporate exposures in securitisations in which the bank acts as investor and lacks the requisite data.

About AFME

The Association for Financial Markets in Europe (AFME) is the voice of the leading banks in Europe's financial markets, providing expertise across a broad range of regulatory and capital markets issues. We represent over 150 leading global and European banks and other significant market players. Our members play a vital role in Europe's financial ecosystem, underwriting around 90% of European corporate and sovereign debt, and 85% of European listed equity capital issuances. Importantly, AFME members are market makers, providing liquidity, which is essential for ensuring financial markets can function efficiently. We also represent law firms and other associate members which advise market participants and support AFME's legal and regulatory initiatives.

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