afme/
Finance for Europe

Association for Financial Markets in Europe

Position paper
New STS framework for on-balance-sheet securitisations
September 2020

Introduction

AFME and its members welcome the European Commission's legislative proposal for the new STS framework for on-balance-sheet securitisations published on 24 July 2020.

We thank the Commission for its efforts to facilitate economic recovery following the COVID–19 pandemic and for recognising the importance of preparing or upgrading "any tools allowing banks to maintain and even enhance their capacity to lend to the real economy, in particular to SMEs" and that "securitisation can be a key enabler in this respect."[1]

We therefore believe strongly that a STS framework for on-balance-sheet securitisations is justified and will provide greater opportunities for banks to transfer appropriate risk to suitable non-bank investors which, with due recognition of capital relief for originator banks, will enable them to increase lending to the real economy.

In general terms, we agree with the amendments proposed to the Securitisation Regulation and to the Capital Requirements Regulation[2] (CCR). The proposals are reasonable and could, with only a few adjustments, be applied to a large number of existing on-balance-sheet securitisations. Accordingly, we believe the STS framework for on-balance-sheet securitisations should and can be implemented swiftly to allow an element of capital relief for originators.

Nonetheless, below we address certain key points on which we feel that the Commission's proposals could be enhanced, without undermining the principles on which the concept of STS securitisation is based, and which are crucial to ensuring that a STS framework for on-balance-sheet securitisation really does provide the most benefit in terms of facilitating bank support for the real economy, especially in the difficult months and years ahead as the recession triggered by COVID-19 bites.

In the sections below we provide specific comments on the European Commission's proposals and additional observations on the proposals and historical context. Please also refer to AFME's separate "Questions and Answers on a new framework for on-balance-sheet securitisations", available on AFME's website.

[1] Explanatory Memorandum to Securitisation Regulation proposals at: https://ec.europa.eu/finance/docs/law/200724-securitisation-review-proposal_en.pdf

[2] The Capital Requirements Regulation proposals at: https://ec.europa.eu/finance/docs/law/200724-crr-review-proposal_en.pdf

Association for Financial Markets in Europe
London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700
Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971
Frankfurt Office: Bürohaus an der Alten Oper, Neue Mainzer Straße 75, 60311 Frankfurt am Main, Germany
T: +49 (0)69 153 258 967
www.afme.eu

Preliminary observations and historical context

The following introductory observations seek to provide background and address potential questions.

On-balance-sheet securitisation is much simpler than traditional securitisation

On-balance-sheet securitisation is actually extremely simple. It is no more than an agreement between two parties that, if an identified loan suffers a default, the protection seller will compensate the protection buyer for the resulting loss which it suffers. Unlike traditional securitisation, there is no need to transfer the exposures to a SSPE, which greatly reduces the complexity of the legal principles which underpin the securitisation, and consequently, the level of understanding and expertise required by investors to understand the transaction. Indeed, the legal documentation for a typical on-balance-sheet synthetic securitisation is usually much shorter than for a typical traditional securitisation. The mere use of the word "synthetic" to describe such securitisations should not of itself be taken to mean such securitisations must be more complicated. In this regard, we think the Commission's proposal to refer to “synthetic” STS securitisation as "on-balance sheet securitisations" is helpful.

On-balance-sheet securitisations have been widely used and have performed well over many years

All the analysis of EU on-balance-sheet securitisation markets since 2008, including the very comprehensive analysis by the EBA in its May 2020 Report, shows that this portfolio management tool has been widely used by banks in many jurisdictions across the EU and that these securitisations have experienced extremely low loss rates. In particular, there have been virtually no losses affecting the senior tranches of on-balance-sheet securitisations which are retained by the originator. The perception that on-balance-sheet securitisation is risky is based entirely on the pre-2008 experience of *arbitrage* synthetic securitisation, which is a very different product from the *on-balance-sheet* synthetic securitisation which is the subject of the Commission’s proposals.

Further, while it is true that on-balance-sheet securitisation markets tend to be private in nature, the process for recognising significant risk transfer requires notification by the originator to its supervisor, backed up by extensive disclosure and analysis which ensures that originators would not be permitted to recognise significant risk transfer for such transactions unless the required standards are met. The EBA is also in the process of revising the rules governing this notification and review process to provide further comfort in this regard.

There has been careful consideration by regulators of on-balance-sheet securitisation for many years

Although the introduction of the STS label for on-balance-sheet securitistaions, with differentiated capital treatment, will be extremely helpful for banks as they seek to support the economic recovery from the COVID-19 pandemic, it is not correct to say that the proposals are being rushed through. The EBA published its first report setting out potential STS criteria in December 2015 and has been engaged in an ongoing review process on this topic since then. It was against this backdrop that the existing partial STS regime for SME on-balance-sheet securitisation contained in Article 270 of the CRR was extended to include private sector protection (where that is provided on a cash-collateralised basis) when the EU Securitisation Regulation and revised Securitisation Framework was passed into law in 2017. The criteria set out in the EBA’s report of May 2020 are, therefore, the product of very extensive analysis, virtually all of which was carried out before COVID-19.

The new framework will encourage better standards and lower-risk transactions

There is absolutely no evidence to suggest that introducing a STS framework for on-balance-sheet securitisation, with differentiated capital treatment, will lead to riskier transactions or increased leverage. On the contrary, the proposed STS criteria are *more restrictive* that current market practice in a number of respects, in particular in relation to the composition of the securitised portfolio, and this will encourage originators to structure *less risky* synthetic securitisations so as to be able to fit into the new framework and apply the differentiated capital treatment. Further, building on the previous observation, one of the key objectives evident in the EBA's May 2020 report has been to ensure that the criteria will be effective to prevent

riskier transactions from being executed. The fact that the proposals will encourage greater use of on-balance-sheet securitisation should not be seen as a negative outcome. On the contrary, on-balance-sheet securitisation is one of the most cost-effective and low risk portfolio management tools available to banks, and the reforms will simply remove the artificial regulatory barriers which currently apply.

It is not possible for the new framework to lead to greater leverage

In relation to concerns that increased use of synthetic securitisation will lead to excessive leverage, this is again a misconception resulting from conflating on-balance-sheet securitisation which is the subject of these proposals with *arbitrage* synthetic securitisation which was a widely-used speculative financial product seen before 2008, and which had the effect of multiplying losses when defaults occurred. There is zero evidence of arbitrage synthetic securitisations being executed in the EU since 2008 and, more importantly, the proposed STS criteria would clearly exclude such transactions.

In contrast, because an on-balance-sheet securitisation involves the originator hedging risk which exists on its balance sheet, and because both the proposed STS criteria and the existing risk retention requirements (which would continue to apply) prevent the originator from over-hedging that exposure, on-balance-sheet securitisation does not increase leverage in the financial system at all.

While, as is also the case with traditional securitisation, it does concentrate risk in the junior tranches of the securitisation, the total amount of losses which will be suffered following a default does not change. Further, the whole point of on-balance-sheet securitisation is that these riskier tranches are then placed with investors outside the banking system, thus greatly reducing the risk of such defaults to the originator bank.

The new framework is further evidence of the EU as a global leader in "best-in-class" securitisation regulation

While we acknowledge that Basel standards do not yet contemplate that on-balance-sheet securitisation be included in the "STC" framework, or that it would enjoy a differentiated capital treatment, we do not think this should of itself stand in the way of sound policy reform in the EU.

The EU took the lead in developing the STS framework for traditional securitisation, which Basel then followed with its own (very similar) international standards for "simple transparent and comparable" or "STC" securitisation. We believe that by once again demonstrating leadership, and the viability of a STS framework for on-balance-sheet securitisation, the EU can again argue for such a regime at the Basel level.

Further, for many years, on-balance-sheet synthetic securitisation has been much more widely used by EU banks than by banks in other jurisdictions, and the topic is therefore of much more direct relevance to the EU than it may be in those other jurisdictions.

As the EBA has noted, EU capital rules already deviate from Basel standards in a number of ways which have been determined to be appropriate in the EU context, and we submit that on-balance-sheet securitisation is clearly such a case given its much greater importance to EU banks than to banks in other jurisdictions. EU capital rules need to take into account the reality of how the EU financial system operates, and recognise where there are differences between the EU and other jurisdictions.

By widening protection to the private sector, the new framework builds positively on Article 270 of the CRR

When the existing form of Article 270 was proposed in 2015, it would have only permitted a differentiated capital treatment for the senior tranche in SME on-balance sheet securitisations where the protection was being provided by a public sector entity.

As noted above, and largely as a result of the EBA's early work in this field, that was expanded in the final version of Article 270 to allow also for private sector protection. In our view, this was entirely appropriate.

While the public-sector remains an important participant in synthetic securitisation markets, as evidenced by the extensive activities of EIF, one of the major benefits of synthetic securitisation is that it enables banks to

transfer risk to private investors outside the banking system, and thus reduce the systemic risk which such losses present to the banking system. This is also consistent with the policy expressed in other EU regulatory reforms, such as the Bank Resolution and Recovery Directive, to limit the circumstances in which public funds may need to be used to support or "bail out" banks in times of financial difficulty. It would therefore be entirely counterproductive if any differentiated capital treatment which applied to on-balance-sheet STS securitisation were limited to only those transactions where the protection was provided by a public-sector entity.

Specific comments on the European Commission's proposals for a STS framework for on-balance-sheet securitisations

1. *Requirements relating to standardisation: Servicing – Article 26c(7)(b) and (e)*

   The current Commission proposals relating to standardisation require that the transaction documentation shall clearly specify, among other things, the provisions that ensure the replacement of the servicer, in the event of default or insolvency. In on-balance-sheet securitisations, the originator will usually be the servicer, and because the originator remains the lender of record, it is not usually possible to appoint a replacement servicer. Indeed, there are virtually no examples of this being provided for in any on-balance-sheet securitisation in the market as it is not necessary or required by investors.

   We therefore propose that in relation to servicing, the transaction documentation should specify instead the processes and responsibilities necessary to ensure that, when servicing is not provided by the originator itself (or one of its affiliates), the default or insolvency of the current servicer does not result in termination of servicing. This will also align with the EBA's Report on STS framework on synthetic securitisation (EBA Report)[3], Criterion 19.

2. *Minimum rating threshold for cash deposit banks – Article 26e(9)(b)).*

   As currently proposed by the Commission, Article 26e(9)(b) imposes a minimum rating threshold for cash deposit banks of Credit Quality Step (CQS) 2 . Such a requirement would exclude many European banks from being able to hold cash collateral and would significantly limit the size of the potential STS market. It is also inconsistent with the requirements for unfunded protection, where Article 249(3) in its current form requires an ongoing rating of only CQS 3.

   Furthermore, the proposed amendment to Article 249(3) of the CRR will remove the minimum rating requirement for exposures to credit institutions. Thus, if a rating of CQS 2 is required for cash collateral, that would effectively impose a higher standard on the originator than would apply if it was purchasing unfunded credit protection from another credit institution. We note that the EBA Report did not prescribe what the minimum rating should be, but left that open to the parties to agree for each transaction.

   By way of comparison, most on-balance-sheet securitisations in the market where cash collateral is provided apply a minimum rating requirement which corresponds to BBB or BBB-, and if a minimum rating is to be specified we submit that this would be more realistic. We further note that, from the originator's perspective, it is exposed to zero credit risk when the cash is held on deposit with itself, so imposing a minimum rating requirement should be seen solely as for the benefit of the investors, not for the originator.

   We therefore recommend adjusting the minimum rating requirement in Article 26e(9)(b) to a minimum credit quality which is specified in the transaction documentation.

[3] EBA Report on STS framework for synthetic securitisation, 6 May 2020: https://eba.europa.eu/eba-proposes-framework-sts-synthetic-securitisation

3. *Exceptions for public schemes - Article 26b (12) and Article 26e(3)*

<u>*At least one payment requirement*</u>

As currently proposed, Article 26b(12) requires that at least one payment should be made by the debtor at the time the exposure is added to the securitised portfolio, with an exception for revolving transactions and refinancing of exposures already included in the securitisation.

Many on-balance-sheet securitisations where the protection provider is a central government or multilateral development bank (such as EIF) are executed to facilitate new lending, on the basis that the newly-originated exposures will be added to the portfolio as they are originated. The efficacy of these transactions would be undermined if the originator was required to wait for an initial payment before those newly-originated exposures could be added to the portfolio.

<u>*Credit protection agreement*</u>

The Commission proposals concerning the credit protection agreement requires that credit protection premiums to be paid under such agreement shall be structured to be contingent on the performance of the underlying exposures and reflect the risk of the protected tranche. For those purposes, the credit protection agreement shall not stipulate guaranteed premiums, up-front premium payments, rebate mechanisms or other mechanisms that may avoid or reduce the actual allocation of losses to the investors or return part of the paid premiums to the originator after the maturity of the transaction.

This is in general reasonable. However, it is not uncommon for some public-sector schemes to require a usually small up-front payment. Therefore, in order to ensure that public schemes are not excluded from credit protection, we strongly suggest exempting from Article 26e (3) cases where the credit protection takes the form of a guarantee from an entity that qualifies for a 0% risk-weight under Chapter 2 of Part Three, Title II of the CRR.

4. *Differentiated Capital Treatment*

Unlike the current position for traditional STS securitisations, in which all tranches in the securitisation benefit from reduced risk weights for both the originator and investors, the Commission proposal for on-balance-sheet STS securitisations would allow only the originator to apply a STS risk- weight to the senior retained position in the securitisation.

This is reasonable and does not cause us concern as in most cases the originator does retain the senior tranches in a balance sheet synthetic securitisation.[4] However, we would suggest a minor adjustment so that instead of the STS risk-weight being limited *solely to the most senior retained tranche*, the originator would also be permitted to apply a STS risk-weight to *any contiguous series of retained tranches which included the most senior tranche* and which have an attachment point, at a closing date, which is equal to or above the K_{IRB} or K_{SA} of the securitisation, as applicable.

Importantly, this change would not represent a significant departure from the Commission's proposal. Indeed, it will not make any difference where the originator applies the SEC-IRBA or SEC-SA methodology. This is because, where either of those methodologies apply, there will only ever be one retained tranche which is senior to the tranche(s) placed with investors, and which will therefore represent all of the portfolio above those placed tranche(s).

However, where the SEC- ERBA methodology is used, it will make a difference, because in order to optimise the rating on the most senior tranche, it is usually necessary to divide the retained position into a number of sub-tranches (which does not in any way change the credit risk retained by the originating bank). Where these separate tranches are all retained by the originator, it would therefore be consistent with the SEC-IRBA or SEC-SA outcomes for the STS risk-weights to apply to *all* of those retained tranches.

[4] This is also consistent with the EBA's preference not to make it more favourable for banks to invest in other banks' synthetic securitisations – a position with which AFME members generally agree

The differentiated capital treatment for any contiguous series of retained tranches is particularly important to many smaller banks. This is because most of the smaller banks are standardised banks, which means they cannot use the more favourable SEC-IRBA approach, but have to use the other approaches. Where they are seeking to apply the SEC-ERBA methodology, they will therefore usually need to divide the senior retained portion into two or more senior and senior mezzanine tranches for a capital relief securitisation to be economically viable. By not extending the capital benefit to the senior contiguous tranches, the amount of capital relief is less, and thus the effective cost is higher when compared to that which can be achieved by an advanced IRB bank. Please also see Annex 1 which illustrates the effect which the introduction of this adjustment would have on banks using the SEC-ERBA methodology.

Because preferential capital treatment only applies to the originator, extending the STS risk-weight to the retained contiguous tranches will not encourage other banks to invest in those tranches, because they would not be in a position to benefit from this reduced risk-weight.

We therefore view this change as more in the nature of ensuring consistent treatment across the different methodologies and different types of banks found across the EU. It is also entirely consistent with the principles underpinning the EBA's proposals.

5. *Unfunded Credit Protection (Article 26.7)*

Recital 20 of the proposed amendments to the Securitisation Regulation include rules for the types of entities which can be the protection seller in an unfunded STS on-balance-sheet securitisation. While the Commission proposals allow unfunded on-balance-sheet securitisations with entities like the European Investment Fund (EIF) to be classified as STS, they do not do so for private-sector protection sellers, such as insurance companies.

While to date the bulk of the balance sheet synthetic securitisation market has involved funded credit protection, there is nonetheless a sizeable portion of the market which uses unfunded protection and in recent years highly-rated insurance companies have emerged as an important investor class. In particular, insurers can be very helpful in providing additional mezzanine protection in excess of the first loss protection which may be provided by traditional funded investors. Unfortunately, under the current proposals an on-balance-sheet securitisation involving those private-sector protection providers would not be eligible for the STS label.

While unfunded protection does mean that the originator has additional exposure to the protection seller (which would not be the case in a funded on-balance-sheet securitisation), this additional risk is appropriately captured through the risk-weight which the originator would be required to apply for its exposure to the protection seller, as is already the case under the CRR.

Furthermore, an unfunded protection seller does not incur any greater risk for itself by investing in an unfunded on-balance-sheet securitisation than it would in a funded on-balance-sheet securitisation. On the contrary it actually incurs less risk because it is not exposed to any risk in relation to the return of collateral it may provide. Thus, from an investor protection point of view, that objective would in no way be adversely impacted by allowing unfunded balance-sheet securitisations to qualify for STS.

6. *Credit Quality Steps - Article 249(3) CRR*

We understand that Article 249(3) CRR refers to the credit quality steps as specified in the EBA Implementing Technical Standards on ECAI mapping under the Article 136CRR[5], nevertheless we recommend clarifying that point and including an explicit reference to Article 136 as is the case under the Securitisation Regulation.

[5] https://eba.europa.eu/sites/default/documents/files/documents/10180/2736783/8964d9e2-4902-4df5-9668-8489fcd1f8e0/JC%202019%2011%20(Final%20Report%20Revised%20Draft%20ITS%20Mapping%20CRR)%20(002).pdf

7. *Grandfathering for existing Article 270 transactions*

As currently proposed the CRR does not provide transitional provisions concerning outstanding on-balance-sheet SME securitisations under Article 270. We strongly believe that providing such grandfathering is essential to ensure that the existing "Article 270" positions which have been structured to meet the traditional STS securitisation criteria (as modified by the existing Article 270a CRR) can continue to apply the STS risk-weight without needing to be restructured to comply with the new STS criteria for on-balance-sheet securitisation.

However, where institutions did not previously apply Article 270 to an existing on-balance-sheet securitisation, they should be permitted to apply the new Article 270 where the securitisation satisfies the transitional provisions in the proposed new Article 43a of the Securitisation Regulation.

We would be pleased to discuss any of these comments in further detail, or to provide any other assistance that would help facilitate your review and analysis.

AFME Contacts:

Richard Hopkin	**Anna Bak**	**Pablo Portugal**
richard.hopkin@afme.eu	anna.bak@afme.eu	pablo.portugal@afme.eu
+44 (0)20 3828 2698	+44 (0)20 3828 2673	+32 2 788 3974

Annex 1: STS for Synthetics – Senior Contiguous Tranches

Annex 1

STS for Synthetics – Senior Contiguous Tranches

- Differentiated STS capital treatment should be extended to **non-senior tranches** where a) retained by the originator and b) are contiguous with the retained senior tranche
- SEC-ERBA – Have to divide into more tranches to meet Rating Agency requirements; **risk to the originator remains unchanged**
- Will help to provide a more **level playing field** for IRB and Standardised banks
- Note that in the example provided, the capital relief for the suggested approach when using SEC-ERBA still remains **c.20%** below the SEC-IRBA approach

SEC-IRBA – *Illustrative Example (EUR 1bn)*

	TRANCHE	NON-STS	STS
Retention (5%)	Senior EUR 890m (Retained)	15%	10%
K_{IRB}	Mezzanine EUR 100m (Placed)	0%	0%
K_{IRB}	First Loss EUR 10m (Retained)	1250%	1250%
CAPITAL CHARGE:	80	21	17
CAPITAL SAVINGS:		59	63
CAPITAL SAVINGS (%):		74%	79%
ADDITIONAL STS CAPITAL SAVINGS:			6.00%

SEC-ERBA – *STS Preferential Capital Treatment for Senior Tranche Only*

	TRANCHE	NON-STS	STS
Retention (5%)	AAA EUR 790m (Retained)	20%	10%
Retention (5%)	AA EUR 50m (Retained)	120%	120%
Retention (5%)	BBB EUR 50m (Retained)	310%	310%
K_{SA}	BB EUR 50m (Placed)	0%	0%
K_{SA}	NR EUR 50m (Placed)	0%	0%
K_{SA}	NR EUR 10m (Retained)	1250%	1250%
CAPITAL CHARGE:	80	40	34
CAPITAL SAVINGS:		40	46
CAPITAL SAVINGS (%):		50%	58%
ADDITIONAL STS CAPITAL SAVINGS:			15.74%

SEC-ERBA – *STS Preferential Capital Treatment for Senior Contiguous Tranches*

	TRANCHE	NON-STS	STS
Retention (5%)	AAA EUR 790m (Retained)	20%	10%
Retention (5%)	AA EUR 50m (Retained)	120%	70%
Retention (5%)	BBB EUR 50m (Retained)	310%	255%
K_{SA}	BB EUR 50m (Placed)	0%	0%
K_{SA}	NR EUR 50m (Placed)	0%	0%
K_{SA}	NR EUR 10m (Retained)	1250%	1250%
CAPITAL CHARGE:	80	40	29
CAPITAL SAVINGS:		40	51
CAPITAL SAVINGS (%):		50%	63%
ADDITIONAL STS CAPITAL SAVINGS:			26.20%
			19%

ASSUMPTIONS:

1. Underlying assets have a RW of 100%
2. Bank has a target CET1 ratio of 8%
3. SEC-ERBA - For simplicity, assumed that each tranche has a M_T of 5 years
4. SEC-ERBA - Ratings mappings based on S&P, using guidance in EBA Q&A 2018_4274