Questions and answers on a new STS framework for on-balance-sheet securitisations

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Introduction

On 24 July 2020 in its package of capital markets measures to support the economic recovery in response to the COVID-19 pandemic, the European Commission proposed a new simple, transparent and standardised (STS) securitisation framework for on-balance-sheet securitisations.

AFME believes strongly that a STS framework for on-balance-sheet securitisations is justified and will provide greater opportunities for banks to transfer appropriate levels of risk to suitable non-bank investors and – with thanks to the recognition of capital relief for the transferring banks - will enable them to lend more to the real economy.

Below we address some potential questions regarding on-balance-sheet securitisations and the STS framework for that type of transactions, and in Annex 1 provide information on the evolution of this market since the 2008 financial crisis.

Questions and Answers

1. What is securitisation?

Securitisation, whether executed in a traditional or "on-balance-sheet" structure, is a mechanism for financing real economy assets and managing banks' risks. The relative importance of each of these two objectives – financing and risk transfer – varies depending on the type of securitisation undertaken.

Traditional, also known as "true sale" or "cash" securitisation is the process of pooling together a large number of loans (such as mortgages or other loans such as loans to purchasers of automobiles, to SMEs, or rooftop solar energy loans) held on the balance sheet of a bank or other financial institution (the "originator") and selling them to a newly created and legally separate entity (the "Securitisation Special Purpose Entity" or "SSPE"). This SSPE finances the purchase of the loans by issuing bonds to investors. The loans generate cashflows (for example, monthly mortgage payments from homeowners), which are used to repay the investors. In this way, loans which would otherwise be illiquid can be converted into more liquid and tradeable securities.

2. What is the difference between "true sale" and "on-balance-sheet" securitisation?

Essentially the difference is in the purpose of the securitisation: is the purpose mainly financing (possibly with risk transfer too)? Or is the purpose solely to transfer risk (it may be cheaper for the originator to raise finance by issuing other, cheaper instruments)?

In "true sale" or "cash" securitisation the SSPE raises cash for the originator (and can, depending on how the transaction is structured, also transfer risk to the investors). The purpose is therefore mainly financing (possibly also with risk transfer).

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In on-balance-sheet, also known as "synthetic" securitisation, the purpose of the transaction is only risk transfer. This means that there is no sale of assets from the balance sheet of the originator - and often no SSPE. While the portfolio of assets is identified on the balance sheet of the originator, the risk of the portfolio is transferred by the purchase of a guarantee on the defined portfolio of assets from a third-party investor. Orginator banks can then apply to their supervisors to obtain regulatory capital relief for the risk transferred which in turn enables them to increase their capacity to provide new loans.

3. Is on-balance-sheet securitisation more complicated 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.

4. Why does the real economy need on-balance-sheet securitisation? And why it is important now?

By providing a risk transfer tool for banks, it makes it easier for banks to lend more to new borrowers, including homeowners, consumers, SMEs and entrepreneurs. On-balance-sheet securitisation is especially helpful to securitisation of corporate and SME loans, which are both capital-intensive when held on balance sheet and difficult to securitise in the cash markets. Without this mechanism banks would be more constrained in their capacity to lend and consequently SMEs and other corporate borrowers would be less able to obtain financing they need to develop their businesses.

This is all the more important today, when businesses are facing disruption in supply chains, temporary closures and reduced demand caused by the COVID-19 pandemic and new funding is needed more than ever.

5. Why would an originator choose "on-balance-sheet" securitisation rather than traditional securitisation?

Primarily when an originator was looking mainly to transfer risk rather than raise funding for itself.

The corporate and SME loans mentioned above are the essence of "relationship banking", where the originator bank prefers to maintain a close link with its customer and therefore chooses to retain the securitised loans on its balance sheet.

Furthermore, many corporate facilities (both large corporates and SMEs) often have transfer restrictions which make it legally impossible to achieve a true sale – which is a requirement for traditional securitisation. These types of loans are also usually revolving in nature[1] and frequently are subject to an ongoing review and amendments to address changing borrower circumstances. If these loans were transferred to a SSPE (as is the case in traditional securitisation), the SSPE would find it difficult to manage revolving drawings and repayments efficiently, nor would it be in position to execute any necessary changes in a timely and cost efficient manner. Yet the flexibility to draw and repay cash under the loans are essential for the borrower. Therefore, an on-balance-sheet securitisation allows the originator bank to maintain the management of the loan on its balance sheet and the relationship with its borrower while at the same time transferring the risk and (subject to supervisory approval) obtaining the necessary capital relief to continue to make new loans to other borrowers.

[1] The loan facility is renewed on ongoing basis and amounts of cash drawn and repaid thereunder vary over time.

6. How well have on-balance-sheet securitisations performed over the 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.

7. Are there special risks associated with on-balance-sheet securitisation?

No. If anything there are fewer risks with on-balance-sheet securitisation as there is no SSPE and true sale of the assets.

Further, there is strong alignment of interests between the originator and investors in an on-balance-sheet securitisation. First, the originator bank typically retains the senior tranches of risk on the assets. The investor guarantee is for the mezzanine or tranches. Second, these transactions invariably reference high quality, core lending portfolios, where the originator wishes to be able to continue lending, but is otherwise constrained by credit limits or capital requirements. Third, the originator retains the servicing and management of the loan portfolio; indeed investors are very keen to see this and undertake detailed due diligence on this aspect of the transaction. Fourth the structure typically includes a verification agent, whereby the eligibility of exposures, occurrence of credit events and the calculation of losses are all verified by an independent third party.

Lastly, the Commission's proposal is that, as for every other kind of securitisation, on-balance-sheet securitisation should be regulated by the Securitisation Regulation[2] (amended as appropriate for the particular characteristics of on-balance-sheet securitisation) which imposes strict requirements for disclosure, due diligence and risk retention.

8. What is "simple transparent and standardised" or "STS" securitisation?

"Simple transparent and standardised" or "STS" securitisation is a sub-set of all securitisations created by the Securitisation Regulation. STS securitisations comply with a defined set of eligibility criteria and other requirements established in the Securitisation Regulation. They were introduced by the European Union in order to restore investor confidence and support the recovery of the European securitisation markets which were damaged after the 2008 financial crisis when serious errors made in US sub-prime mortgage lending spread through the global financial system. Most European securitisations have performed very well in both credit and liquidity terms through the 2008 financial crisis and since then, although investor confidence was damaged and has taken many years to recover.

The Securitisation Regulation also defines universal legal requirements for all securitisations – not just STS securitisations – dealing with disclosure, due diligence and risk retention (or "skin in the game").

[2] Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation.

9. Why is the Commission proposing a STS framework for on-balance-sheet securitisation?

During the period of severe economic stress caused by the COVID-19 pandemic it will remain key for banks to be able to continue lending, in particular to corporates and SMEs. On-balance-sheet securitisation can be a key mechanism for banks to continue to provide funding to those and other sectors of the real economy. However Level 1 legislation is needed because "the current [securitisation] framework does not cater for on-balance-sheet securitisation"[3] which is therefore not eligible for a STS label or for any preferential capital treatment (which is the case for "true sale" securitisations).

Therefore, to provide banks with the necessary tools to allow them to continue lending and to enhance their lending capacity, the Commission has proposed the new framework for STS on-balance-sheet securitisations, under which an on-balance-sheet securitisation which complies with the set of specific STS criteria would then be eligible for STS designation and, subject to supervisory approval of the risk transfer, the originator bank would be able to benefit from the preferential capital relief treatment under the CRR.

The proposed framework will also further increase transparency in relation to on-balance-sheet securitisation and in time will lead to greater standardisation of such transactions in a way which conforms to what are seen as "best practice" standards. Greater standardisation will also make it easier for investors to compare transactions across different originators and jurisdictions.

10. Have regulators considered on-balance-sheet securitisation before the Commission proposal?

Although the introduction of an STS label for on-balance-sheet securitisations, 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. Quite the contrary.

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.

11. Why is the Commission proposing a new prudential framework for STS on-balance-sheet securitisation?

The Commission has stated that "the development of STS eligibility criteria in itself would not be sufficient to achieve the objective of making the compliance with these criteria economically viable if the introduction of the new criteria is not accompanied with a more risk-sensitive prudential treatment in the area of capital requirements"[4].

Therefore based on the EBA's extensive analysis of the on-balance-sheet securitisation market[5] the Commission has also proposed a targeted differentiated prudential treatment for STS on-balance-sheet securitisations undertaken by the originator bank, which takes into account the transfer of risk achieved.

This is an essential aspect of this new framework without which originator banks will have little incentive to undertake on-balance-sheet securitisations which in turn will make it more difficult and expensive for banks to provide financing to home-buyers, consumers, corporates and SMEs which are crucial to the European real economy.

[3] https://ec.europa.eu/finance/docs/law/200724-securitisation-review-proposal_en.pdf
[4] https://ec.europa.eu/finance/docs/law/200724-crr-review-proposal_en.pdf
[5] EBA "Report on STS framework for synthetic securitisation", 6 May 2020

12. Will the new framework encourage better standards and lower-risk transactions?

Yes. And 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* on-balance-sheet 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.

13. Will a STS framework for on-balance-sheet securitisation create excessive leverage?

No. While during the global financial crisis of 2008 some synthetic (note we do not say "on-balance-sheet") securitisations did create excessive leverage, it is very important to distinguish between "on-balance-sheet" and "arbitrage" synthetic securitisations.

The securitisations which exhibited excessive leverage were almost exclusively "arbitrage" transactions. This is a market which has effectively ceased to exist since 2008. Certainly, such transactions are <u>not</u> included within the scope of the STS framework proposed by the Commission, which is expressly restricted to "on-balance-sheet" transactions.

As the name suggests, an on-balance-sheet synthetic securitisation involves an originator purchasing a guarantee for exposures which it actually holds on its balance sheet. As such, it is actually *not possible* for transactions within the scope of the STS framework proposed by the Commission to facilitate exposure to the performance of assets that the originator has not financed. There is no multiplication of losses. Rather, instead of the originator suffering the loss if an underlying exposure defaults, the investor (the provider of the guarantee) suffers that loss, in the same amount as would otherwise have been borne by the originator.

In addition, Article 8 of the Securitisation Regulation effectively bans re-securitisation, and thus the type of CDO-squared or CDO-cubed structures seen before the global financial crisis of 2008 are no longer permitted in the EU. Further, the risk retention requirements in Article 6 of the Securitisation Regulation effectively make it impossible for an originator to purchase a nominal amount of protection which is greater than its actual exposure to the underlying loans.

Consequently, on-balance-sheet securitisation included the Commission 's proposals would *not* result in any excessive leverage. Indeed, in this regard, there is no difference between such on-balance-sheet and true-sale securitisations.

14. Does on-balance-sheet securitisation require the use of complex derivatives?

The short answer is no.

Complex derivatives could be seen as inconsistent with the "simplicity" and "transparency" elements of the STS framework. The "arbitrage" securitisations seen before 2008 did use credit default swaps ("CDS"), which could be quite complicated. However, since 2008 the market has evolved in such a way that this is no longer the case.

First, the vast majority (around 90%) of on-balance-sheet securitisations executed over the last 10 years have used a financial guarantee to transfer the risk from the originator to the investors, and it is now relatively rare to see synthetic securitisations which use CDS. Further, even in those transactions which

do still use CDS, the terms of the CDS are much simpler, and economically equivalent to a financial guarantee.

Therefore, the types of on-balance-sheet synthetic securitisations that would satisfy the STS criteria proposed by the Commission are actually relatively simple transactions, and do not suffer from the type of complexity that is characteristic of many CDS. And complex derivative instruments are not required.

15. Are there concerns arising from the impact of maturity transformation on risk transfer?

No. This is because the underlying assets in the on-balance-sheet transaction are not sold to an SPPE and therefore there is no re-financing risk in this type of securitisation[6].

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[6] EBA "Report on STS framework for synthetic securitisation", 6 May 2020 (para.104a).

Annex 1

Changes since 2008 in the on-balance-sheet securitisation market

The on-balance-sheet securitisation market in 2020 looks very different from the pre-2008 market. As already noted above, the biggest changes have been the virtual disappearance of "arbitrage" synthetic securitisations, together with the CDO-squared and CDO-cubed transactions which were responsible for magnifying losses during the financial crisis. What remains are "on-balance-sheet" securitisations, which always involve the Originator securitising a portfolio of exposures which it holds on its balance sheet. These are the types of transactions which would be eligible for STS classification under the Commission's proposals.

While to a certain extent the transformation of the market was the result of the changing views of market participants, these changes have been reinforced by the various regulatory initiatives which have been introduced in the intervening years. Of these, the most important are the following:

(a) *Risk retention:* Although it was always relatively common for the originator in an on-balance - sheet securitisation to retain some exposure either subordinated to or pari passu with investors' exposure, these requirements were formalised with the introduction of Article 122a of the Capital Requirements Directive, now reflected in Article 6 of the Securitisation Regulation. Together with the fact that the Commission proposal requires that the securitised exposures are held on the balance sheet of the originator, this ensures that the originator will always have an alignment of interest with the investors in an on-balance-sheet securitisation in the same way as for a traditional securitisation.

(b) *Ban on re-securitisation:* Re-securitisation is now prohibited by Article 8 of the Securitisation Regulation, and would also be completely prohibited for STS by proposed Article 26b(8). This had also effectively already been achieved by the much higher risk weights which applied to re-securitisation positions under the CRR prior to the introduction of the Securitisation Regulation (see, e.g., former Article 261 of the CRR), which would have made such transactions uneconomic for most originators due to the high risk weights which would have applied to the retained senior tranche(s). Taken together, this has ensured that CDO-squared and CDO-cubed transactions have disappeared from the market.

(c) *Mandatory disclosure and reporting requirements:* Prior to the introduction of former Articles 408 and 409 of the CRR, disclosure and reporting in relation to on-balance-sheet securitisations was essentially a private matter to be agreed between the originator and investors (although in the case of listed transactions, some disclosure standards were imposed by the relevant listing rules). Of course, simply because disclosure is a matter of private negotiation does not mean that the standard of such disclosure is lower. On the contrary, it has always been the case that investors in on-balance-sheet securitisations undertake very detailed due diligence commensurate with the fact that they are investing in the riskier tranche(s) of the capital structure, and originators are well-accustomed to providing detailed disclosure and reporting to investors both prior to execution and over the life of the transaction. This disclosure covers both the underlying exposures, as well as the originator's systems and policies for managing the exposures. Accordingly, it is fair to say that investors in balance sheet synthetic securitisations over the past 10 years have been among the most informed of investors in any securitisation products, and there has been a very high degree of transparency between originators and investors.

Again, it is important to draw the distinction here between on-balance-sheet securitisations and arbitrage transactions. Prior to 2008, many arbitrage securitisations were structured specifically for the purpose of generating a particularly high yield for investors, and accordingly were also structured to be high risk. Given the more speculative nature of those transactions, and the fact that the protection buyer was not also the originator of the underlying exposures, the level of disclosure and diligence was generally much lower. However, the position is completely different for on-balance-sheet synthetic securitisations, which are not viewed by investors as speculative investments. Rather, investors approach these transactions on the basis of a very clear understanding of the risks involved (and their

ability accurately to price that risk), and with the expectation that each investment will perform satisfactorily over its life. They can only make such an assessment when in possession of all the material information.

Of course, these disclosure and reporting requirements have been further formalised by Article 7 of the Securitisation Regulation, and the corresponding reporting templates which are due to come into effect in September 2020. While there are a number of challenges in applying these templates for many on-balance-sheet securitisations, largely as a result of their having been prepared with primarily traditional cash securitisation rather than on-balance-sheet securitisation in mind, what is clear is that originators are now *obliged* to make very detailed disclosure about a securitisation and the underlying exposures, regardless of whether or not the investors make such a request. While, as noted above, the practice in on-balance sheet securitisation markets has always been for investors to request and receive detailed information, the Article 7 requirements ensure that this is now a mandatory requirement in any on-balance-sheet securitisation. These disclosure requirements would be still further enhanced under the STS framework by the additional disclosure requirements proposed under Article 26d.

(d) *EBA Guidance and SSM:* The establishment of the EBA, as well as the SSM and JST supervisory framework of most of the Eurozone banks which have been active in this market, has also had a significant impact in harmonising securitisation transactions involving risk transfer across the EU over the last 10 years in a way which accords with sound prudential capital management. In particular the various items of guidance and papers published by both the EBA and the ECB have helped to clarify the requirements for achieving significant risk transfer for on-balance-sheet securitisations in a way which has also ensured that many of the riskier or more complex features found in that type of transactions prior to 2008 are no longer seen. The result has been much greater standardisation of on-balance-sheet securitisations across the EU. This trend is continuing, with the EBA expected to publish further guidance on significant risk transfer in the coming months.

Taken together, any concerns around a lack of transparency in relation to on-balance-sheet synthetic securitisations which would satisfy the criteria for STS have been well and truly addressed.

While the on-balance-sheet securitisation market remains relatively private (when compared to traditional securitisation), as stated above this should not be misinterpreted as suggesting there is therefore a lack of transparency. As between the parties to the transaction, there is a very high level of disclosure. In addition, any originator which is seeking to achieve significant risk transfer (and thus to apply the securitisation risk-weights) is required to notify its supervisor in advance, and to provide extensive additional information to the supervisor about the transaction. Originators are also required under Article 7 of the Securitisation Regulation to make the ongoing reporting information available to their supervisors. Accordingly, regulators also have very extensive information about these transactions. We have also started to see greater readiness by some originators to make transaction information publicly available, such as through the European DataWarehouse.