afme/ Finance for Europe

8 February 2021

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By email

2020 EU-wide Stress Test – Treatment of Balance-Sheet Synthetic securitisation allocated to Risk Bucket 3

Dear Mr. Quagliariello,

We are writing to point out an issue with regards to the treatment of synthetic securitisations in this year's stress test and to ask for your advice on how it might be resolved. The updated templates will allocate synthetic securitisation into Risk Bucket 3 for the first time. This treatment is not only inconsistent with the underlying risk profile of the majority of the underlying on-balance sheet portfolios, but it also does not take into account the objectives of the recent amendments to the EU Securitisation Regulation 2017/2402 (the "Securitisation Regulation") known as the Securitisation Capital Markets Recovery Package (the "SCMRP"), expected to be published in the OJEU in the coming weeks.

The Template Guidance specifies that the classification in risk buckets must be performed using as a reference the ESMA central repository (CEREP) and the Committee of European Securities Regulators' (CESR) Guidelines for the implementation of the CEREP. These Guidelines classify assets in six categories including one for instruments that cannot be included in any of the other five categories ("Other structured finance"). The EU-wide Stress Test - Template guidance at point 79 states - for the first time - that "Synthetic securitisations qualify as "other positions" and thus should be allocated to Risk Bucket 3".

This classification implies under the adverse scenario a risk weight of 117% on all synthetic securitisation senior tranches. In our opinion, the allocation to Risk Bucket 3 should be required only for "arbitrage" synthetic securitisations (which are not "on-balance-sheet synthetic securitisations" as defined by "The EBA report on synthetic securitisations" of June 2015[1], as the extent of the risk weight increase from a minimum of 15% is entirely unjustified

[1] https://www.eba.europa.eu/sites/default/documents/files/documents/10180/950548/3c52e2e3-66c2-493f-b3b7-a7d55dc5cd41/EBA%20report%20on%20qualifying%20securitisation.pdf

given the risk profile. Furthermore, the level of 15% is usually obtained after having floored the risk weight of the note in accordance with the credit risk Capital Requirements Regulation which, otherwise, could have been much lower if SEC-IRBA was applied without the floor. Hence, in line with the treatment followed so far in the EU-wide Stress Test, we deem more appropriate that these securitizations are placed into the Risk Bucket that corresponds to their risk profile (e.g., EMEA synthetic RMBS in Risk Bucket 1)

This extremely conservative treatment is also further exacerbated by requiring SEC-IRBA exposures to be mapped in SEC-ERBA credit quality steps (CQS). While externally rated ABS are mapped based on their rating, internally rated tranches treated with SEC-IRBA will in best case scenario end in CQS2. Applying internal ratings to the underlying portfolios seems to result in a disadvantage compared to external ratings. This arguably unintended impact is caused by the EU-wide Stress Test Methodological Note. Point 180 requires banks to remap the exposure after the application of the floor and point 182 requires, in case the weighted average maturity is equally distant from the original maturity, to allocate the exposure to the lower quality CQS step. This is the case specifically with senior notes that are weighted 15% after having applied the floor, whereby they will always satisfy two CQS step criteria, CQS 1 [15% 20%] and CQS 2 [15% 30%], ending up being classified in the latter category.

Balance-sheet synthetic securitisations are transactions which enable banks to manage the credit exposures on their balance sheets by transferring credit risk to third parties. This enables them to extend financing and support further lending capacity to the real economy and in particular SMEs. The underlying portfolios of these transactions are usually domestic corporates, or SME loans held on the balance sheet of the originators. Normally, the originating bank hedges the junior and/or mezzanine tranches through purchasing financial guarantees from third parties - except for the slice of risk the originator itself must retain according to the risk retention requirement of Art.6 of the Securitisation Regulation. The originator typically also holds the most senior tranches. Furthermore, the transactions are structured in compliance with the relevant Reg. EU 575/2013 ("CRR") and Significant Risk Transfer ("SRT") rules adopted by EBA to ensure that a significant and commensurate credit risk transfer from the originator to the investors takes place. In particular, balance-sheet synthetic securitisations need to pass the SRT test as per Art. 245 of the CRR, i.e. junior and/or mezzanine tranches need to be adequately sized to cover both expected and unexpected losses of the securitized portfolio.

Therefore, it is extremely unlikely that retained senior tranches experience any losses. This is also evidenced in the EBA Report dated 6th May 2020 on "A STS framework for synthetic securitisation"[2]. The historical performance provided by market participants collected through IACPM and quoted in that Report shows zero default and loss rate on senior tranches reported for the significant majority of the tranches[3]. In the same report, a comparison between "true sale" and balance-sheet synthetic securitisation has been performed, which indicates that the default performance of balance-sheet synthetics has been better than that

[2] https://www.eba.europa.eu/sites/default/documents/files/document_library/News%20and%20Press/Press%20Room/Press%20Releases/2020/EBA%20proposes%20Framework%20for%20STS%20Synthetic%20Securitisation/883430/Report%20on%20framework%20for%20STS%20syntetic%20securitisation.pdf

[3] Pargraph 56 on page 27.

of traditional securitisations for all asset classes analysed (SME CLOs, RMBS, CMBS and other CLOs).

As EMEA RMBS and EMEA ABS are attributed with a Risk Bucket 1, according to the EU wide Stress Test Methodological Note, this suggests that balance-sheet synthetic securitisations should be treated the same way, given that they share the same risk profile.

Given the publication of the final methodology was on 29 January, AFME and our members would welcome your views on whether this issue might be addressed via a clarification or a stress-test methodology related Q&A process.

The industry appreciates your consideration of this matter and we remain at your disposal in the further development of the stress testing framework.

Yours sincerely,

Jouni Aaltonen
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AFME