Briefing Note

Adjustments to the Securitisation Framework – CRR3 / CRD6

February 2023

Executive Summary

There is a wide consensus among market participants that existing regulatory imbalances have been a key factor in the stagnation of securitisation in Europe. The prudential regulatory framework for banks is one among several critical areas where such imbalances are contributing to holding back the tool's potential to support the European economy[1]. Acting as originators, issuers and investors, banks are central to the functioning of the securitisation market, which can, when thriving, provide crucial sources of liquidity and capital to the real economy through the issuance of risk sharing and capital market securitisations. A proportionate bank prudential capital framework lays the foundation for growth of these products by creating an environment in which transactions are economically viable, whether as a funding or balance sheet management tool.

Considering the importance of securitisation for the overall financing of the economy, EU legislators should use the opportunities provided by the current legislative discussions on the CRR3/ CRD6 Banking Package to introduce immediate and targeted adjustments to securitisation-related calibrations and concrete mandates for more risk sensitive revisions to be undertaken as a subsequent step to address miscalibrations inherent within both the SEC-SA and SEC-IRBA formulations.

In the absence of immediate action, the introduction of the Standardised Approach (SA) Output Floor would exacerbate the effect created by existing regulatory miscalibrations and generate a substantial shock to the one area of the securitisation market in Europe that is growing and is very much needed (i.e. risk transfer transactions), whilst the rest has been subject to an extended period of decline contrasting with the thriving markets in other regions, despite the introduction of the Securitisation Regulation and the EU Simple, Transparent and Standardised (STS) securitisation category in 2019.

Recommendations

To introduce greater risk-sensitivity in the framework and mitigate the severe effects of the output floor it is vital that legislators support the following transitional measures:

- Introducing in Articles 259 and 260 of CRR3 a (p) factor of 0.25 for SEC-SA for STS securitisations and of 0.5 for SEC-SA for non-STS securitisations (for banks acting in the role of originator, sponsor or investor);

- Recalibrating in Articles 259 and 260 of CRR3 the fixed parameters that are components of the (p) factor for SEC-IRBA with a floor of 0.1 and maximum of 0.3 for STS securitisations, and a lowered floor of 0.25 and maximum of 0.75 for non-STS securitisations (for banks acting in the role of originator, sponsor or investor).

[1] Other areas in need of revision (not addressed in this paper) are the prudential framework for insurance company investors, namely Solvency 2, and selected aspects of the Securitisation Regulation. We welcome that a revision of transaction reporting templates is already underway.

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These transitional adjustments should be applied before the output floor and for the output floor itself. They would achieve two outcomes: a) supporting the ongoing viability of risk transfer transactions impacted by the implementation of output floors, and b) creating a level playing field for the market as a whole and for European banks competing with non-EU banks to finance European businesses.

- AFME also supports the re-introduction of a 7% RW floor in all approaches for STS securitisations (cash and synthetic), to be aligned with capital charges for covered bonds, for banks acting in the role of originator, sponsor or investor, and 12% for non-STS transactions. Finally, for both STS and non-STS transactions:
  - A minimum level of granularity of 2% should be applied, instead of the 0.5% recommended by the ESAs;
  - The "thickness of the sold non-senior tranches" criterion proposed by the ESAs should not be implemented to ensure the new rules do not introduce additional cliff-edge risk into the framework.

It is important to stress that the RW floor decrease will be inefficient with the current (p) factors. Only the cumulative proposals above will effectively contribute to the EU market securitisation revival.

Whilst the industry strongly supports the STS framework and promotes STS labelled securitisations, it is important to also emphasise the role of non-STS labelled securitisations in financing the European economy as a risk transfer solution. First of all, it is common for banks to structure SRT transactions as private securitisations tailored to specific investors, where the structure of the deals responds to specific investor constraints and needs that may not necessarily match the STS criteria. In addition, non-STS securitisations are relevant to the provision of warehouse financing to third party non-bank lenders which are keen to develop their ability to issue STS labelled securitisations through the capital markets; providing senior securitisation financing to third parties which provide financing to segments of the retail and non-retail markets that otherwise are not able to access traditional bank lending; and providing senior financing secured against portfolios of mid-sized corporate portfolios, large corporate portfolios and portfolios of specialised lending exposures (e.g. commercial real estate backed loans, aviation / ship financing or infrastructure financing and energy-based financing that is critical to the green energy transition agenda) where the portfolios, for example, may not meet the granularity criteria of STS, or may not have available 5 years of historic data. Originating securitisations that meet the significant risk transfer conditions are an important part of a bank's risk management practice. In particular, non-STS labelled securitisations are an important risk transfer mechanism for portfolios referencing corporate revolving credit facilities, loans to mid-sized corporates and specialised lending exposures including financing of commercial real estate, aviation, ships, project finance and commodities).

Following these transitional arrangements, a full review of the prudential framework for banks, which should cover all formula approaches**,** is needed to ensure that capital and liquidity rules are proportionate to the relative riskiness of European securitisation instruments, and reflect the introduction of the unique and extensive safeguards included in the STS framework as well as the rules applicable to non-STS securitisations in Europe, which go significantly beyond the principles for Simple, Transparent and Comparable (STC) securitisation in the Basel framework and frameworks in other jurisdictions (as illustrated below).

Background: the current Basel framework & securitisation

The Basel framework for securitisation (the "Basel Securitisation Framework") was finalised in December 2014 in very different circumstances from those prevailing today. It was heavily influenced by the experience

of the Global Financial Crisis ("GFC") and in particular the role played by US sub-prime mortgage securitisations and products which no longer exist in the marketplace or have been prohibited by the European regulatory framework (eg, re-securitisations).

Securitisation in Europe has always performed strongly, prior to, through and since the GFC. Credit losses have been minimal. Where they have occurred, they have been confined to defined asset classes, such as commercial mortgage-backed securities and collateralised debt obligations, both of which typically have features which preclude them from qualifying as STS securitisations. The current Basel Securitisation Framework reflected in the EU Prudential Framework is too conservatively calibrated for the European securitisation market, particularly following the introduction of the EU framework for STS and non-STS securitisations which offer additional unique safeguards not stipulated in other jurisdictions or indeed prescribed in Basel recommendations.

The European securitisation product that exists today, when measured against any credit metric over the past 20 years, has demonstrated strong stability in terms of ratings and losses and compares favourably to other fixed income asset classes. Notwithstanding, the product has become the most highly regulated and transparent fixed income asset class in existence.

The Basel Securitisation Framework was implemented in the EU through amendments to the CRR introduced by Regulation (EU) 2017/2401 which entered into force at the same time as the European Securitisation Regulation ((EU 2017/2402)) Key requirements of the Basel Securitisation Framework have been implemented inconsistently across jurisdictions globally. Notably, the latest calibrations of the (p) factor discussed below **have not been implemented in the United States**, which has seen a continuous expansion of its securitisation market in recent years.

The implementation of the output floor will uniquely be a major shock to the European securitisation market – particularly impacting significant risk transfer transactions that support SMEs and corporates and balance sheet transition to green

Due to the layering of conservative parameters embedded in the calculation formula under the Standardised Approach, the output floor will have a disproportionate effect on the treatment of securitisation by a bank originator focused on significant risk transfer ("SRT") by significantly increasing the capital required to be held against any retained senior exposures after securitisation. This effect will be most acutely felt in Europe.

SRT is the only securitisation product type in EU that has grown over the past decade as a result of a deepening non-bank specialist credit investor base unaffected by regulatory capital charges. The introduction of output floors will likely reverse this growth. More broadly, this will only compound the challenges that securitisation faces generally, which has seen a shrinking non-bank investor base, in large part due to conservative calibrations under Solvency 2 in the case of insurance company investors and stringent requirements for all investors (e.g. due diligence) that are unique to European securitisation.

For banks impacted by the output floor, the overly punitive treatment which the output floor imposes on retained exposures post-securitisation will create a very high hurdle and make it very difficult for a bank originator to achieve an attractive capital-adjusted cost of funds for securitisation. This is likely to depress issuance by larger banks, lead to further market shrinkage and reduce the opportunities available for banks to manage and share their balance sheet credit risk with non-bank investors. Prudent risk sharing is an important component of a strong and diversified financial system able to withstand shocks.

The recent study undertaken by Risk Control Limited (November 2022), commissioned by AFME, found that the impact of the output floor (given the current design of the SEC-SA) on the European securitisation market will vary considerably across regulatory asset classes[2]:

- The study shows that for banks affected, SRT securitisations of large corporates and SME loans are likely to be severely negatively impacted, making them scarcely feasible. These portfolios are rarely securitised for funding given the inherent difficulties in achieving asset sale and their specific features (e.g. revolving credits). Therefore, synthetic SRT is one of the few effective tools to mobilise capital on these portfolios. Even in the current subdued European securitisation market, these structures have played an important role: in 2021 in Europe (i.e. EU and UK), significant risk transfer securitisation freed up capital which could be used to support circa EUR 80bn of lending[3].

- At the same time, the study makes observations that the securitisations of consumer loans, including residential mortgages, auto loans and other consumer loans, may be boosted because the increase in capital for loans held on balance sheet will exceed, sometimes disproportionately, that of securitised assets[4].

- These unintended effects are not rooted in a sound methodological analysis, they are rather based on an arbitrary decision taken as to where to set the level of "p". These random effects, be they negative or positive, should not be a reason to avoid addressing current flaws and miscalibrations in the framework.

- In many instances, banks may be unable to fully assess exactly whether/when the output floor would become constraining at *group* level over the subsequent years. Even when a bank is not constrained by the output floor, entering into a securitisation transaction that would reduce its distance to the floor would make it more vulnerable to a potential impact of the output floor over the life of the transaction, due to unrelated balance-sheet structural changes. The uncertainty originator banks would face could deter them from undertaking securitisation transactions at all. While the objective of SRT transactions would be to achieve capital relief, if the output floor were to become binding in subsequent years, these transactions could, on the contrary, become counter-productive for banks as they could actually increase the impact of the OF due to the application of the SEC-SA floored at 72.5%.

- The uncertainty would be extended to the SRT assessment leading to the possibility of regulatory calls being triggered further down the line. AFME members have asserted that some issuers are already reconsidering their SRT pipelines as a result, and they are also concerned about the possibility of a reversal of current capital relief further down the line (if existing SRTs from previous years are called).

While the level of application of the output floor (either at individual or at group level) is still to be decided by the co-legislators, banking groups will likely compute the output floor at transaction-level (i.e. the marginal impact of each securitisation on their total RWAs) to determine the "contribution to the output floor" of each transaction and whether such transactions are cost-effective. Even though a substantial amount of risk will be

[2] See analysis by Risk Control Limited, commissioned by AFME, "Impact of the SA Output Floor on the European Securitisation Market", available on AFME's website.

[3] When we refer to risk transfer, we refer to the technique deployed by banks in transferring expected and unexpected loss on a portfolio of assets originated by the bank, to a non-bank leaving residual risk with the originating bank. The capital calibrations are critical in determining the economic viability of these significant risk transfer (SRT) transactions, as banks have to hold capital against the aforementioned residual risk they retain.

[4] This analysis is based on the Basel framework agreed at the international level and does not anticipate the final provisions in the CRR3.

transferred under an SRT securitisation, there will only be a comparatively small benefit on the post transaction capital ratio. Thus, the output floor reduces the "efficiency" SRT transactions have in this respect. We have included case studies below to illustrate how the output floor impacts securitisations' marginal contributions, both in the case where it is "binding" prior to the securitisation transaction itself, as well as when it is not binding before the securitisation.

These findings evidence that implementation of the SA output floors will likely render ineligible securitisation structures referencing sectors such as SMEs which are specifically the focus of CMU investment whilst potentially benefiting – or having a neutral impact on – other structures arbitrarily.

Finally, even if the implementation of the output floor will be phased-in, its impact on retained senior tranches will apply at an early stage in the phase-in, and given securitisation transactions are typically 5y transactions, their inefficiency toward the end of the phase-in will have to be taken into account for transactions to be issued as early as 2024/2025.

The European securitisation framework achieves high levels of risk mitigation and reduction (well beyond other international frameworks)

The European regulatory framework – both for STS and non-STS securitisations – represents an international "gold standard", with a set of far-reaching safeguards not seen in any other jurisdiction around the world. It is important to take into consideration the robustness of Europe's securitisation framework today in assessing whether the prudential treatment remains fit for purpose and proportionate to the underlying risks.

We set out in the **Annex below** a summary of the areas in which EU securitisation regulation is super-equivalent to (or 'gold-plates') the international Basel standards. The analysis shows that the Basel bank capital and liquidity standards for securitisation affect European banks disproportionately as they apply to European market participants on top of a unique and comprehensive regulatory framework for both STS and non-STS securitisations in Europe, which is significantly more conservative and demanding than any other international regime for this asset class.

AFME's proposals for short-term adjustments to the capital framework (CRR3 / CRD6)

AFME recommends transitional adjustments to the "p" factor for both the SEC-SA and SEC-IRBA until a wider review of the framework is undertaken. This transitional measure is critical for the economic viability of SRT transactions, the main instrument used to share risk and redeploy capital into lending to SMEs, corporates and project finance, as they are the most severely impacted by the CRR3.

Our proposals are as follows:

- Introducing a p factor of 0.25 for SEC-SA for STS securitisations and of 0.5 for SEC-SA for non-STS securitisations (for banks acting in the role of originator, sponsor or investor).

- Recalibrating the fixed parameters that are components of the p factor for SEC-IRBA with a floor of 0.1 and maximum of 0.3 for STS securitisations, and a lowered floor of 0.25 and maximum of 0.75 for non-STS securitisations (for banks acting in the role of originator, sponsor or investor).

These urgent transitional measures should be applied before the output floor and for the output floor itself.

- In addition, we also support the re-introduction of a 7% RW floor in all approaches for STS securitisations (cash and synthetic) for banks in the role of originator, sponsor or investor, and 12% for non-STS transactions. Finally, for both STS and non-STS transactions:
    - A minimum level of granularity of 2% should be applied, instead of the 0.5% recommended by the ESAs;
    - The "thickness of the sold non-senior tranches" criterion proposed by the ESAs should not be implemented to ensure the new rules do not introduce additional cliff-edge risk into the framework.

The transitional adjustments described above are needed to achieve the following outcomes:

1. Improve EU bank competitiveness within EU markets in the short term.
    a. Non-EU banks enjoy competitive advantages through reliance upon their own domestic prudential capital frameworks, such as utilisation by US banks of the Supervisory Formula Approach ("SFA"). This enables these banks to provide non-recourse financing via securitisation to EU clients at more attractive advance rates and pricing levels than European banks. This disadvantage limits the scope of opportunity for EU banks to win business from their EU domestic client base.
    b. To create certainty for EU banks when considering the lifetime economics of new SRT transactions in the context of implementation of output floor on the horizon. This certainty will settle banks' concerns in 2023 that SRT remains a viable risk mitigation tool for the foreseeable future.
    c. Such clarified perspective would allow both banks and investors to re-invest in skills and expertise and (re)develop capacity to originate, structure, analyse transactions, given lack of deal flow has led many investors to disinvest in specialised teams, notably at insurance companies.

2. Support CMU objectives and encourage improved functioning of an EU capital market in the short term until such time that robust SEC-SA and SEC-IRBA formulae are developed and adopted.
    a. Reduced reliance on the banking sector is unlikely to be achieved through a massive shift in borrowing practices for household and small and medium size businesses, which are not in a position to borrow directly from the market. Securitisation can be an efficient bridge to package small loans into a marketable instrument, with risk tranches fitting various investors' risk appetites, from the most senior to the mezzanine and first loss.
    b. Securitisation also has an important role to play in the financing of the transition toward a low carbon economy, given the share of emissions spread over real estate, transportation, businesses, which will require extremely granular loans that can then be repackaged into securitisation tranches.

As noted above, we emphasise that European non-STS labelled securitisations – which are subject to extensive regulatory requirements as illustrated below – also play an important role in financing the European economy in addition to being a prudent risk transfer solution. They should therefore be included in these adjustments, together with STS securitisations.

The proposed adjustments would bring closer alignment between requirements in the EU and those applied in the United States. It is important to note that the US has not implemented the most recent Basel-level calibrations of the (p) factor (in addition to not having implemented a framework comparable to the EU framework in the Securitisation Regulation, the Solvency 2 capital requirements or the more general Basel

STC criteria). The table below illustrates the comparison between the EU and the US in relation to p factor calibration.

We also note that reducing the risk weight floors on retained senior tranches will have no effect in scenarios where the output floor is constraining unless also accompanied by the reduction of the (p) factor (i.e. it would only be helpful as long as the output floor is not binding over the maturity of the transactions).

In scenarios where the output floor is or may be constraining, originators would have to (i) design their transactions under SEC-IRBA, while at the same time (ii) apply the output floor to the transaction, i.e. compute 72.5% of the SEC-SA result[5]. In this context, lower RW floors for senior tranches under SEC-IRBA would be totally unhelpful. Indeed, any reduction in capital requirements achieved thanks to such lower RW floors under SEC-IRBA would not apply due to the application of the SEC-SA floored at 72.5%. To give an order of magnitude, simulations run on real-life transactions structured under SEC-IRBA show that senior tranches would attract a RW between ~50% and ~100%, i.e. 5 to 10 times higher than the current 15%/10% RW floors for non-STS/STS transactions. In other words, simply lowering the RW floors on senior tranches will likely prove to be insufficient since such floors cannot realistically be reached under SEC-SA.

Table: "P" factor implementation – comparison between Europe and the United States

"p factor"		**Europe**	**US**
SEC SA (Art. 261-262)	Current	1 for non-STS 0.5 for STS	0.5 for all transactions – Simplified Supervisory Formula Approach (SSFA)
	AFME Proposal	**0.5 for non-STS** **0.25 for STS**	
SEC IRBA (Art. 259-260)	Current	Floor of 0.3 for STS and non-STS And max ranging from 0.75 for STS to 1.5 for low-risk mortgage pools for non-STS	The Supervisory Formula Approach (SFA) is still in use. While the *p*-factor is not an explicit input in the SFA formula, implicitly it is close to 0.
	AFME Proposal	**For non-STS lower floor to 0.25 and lower max to 0.75** **For STS, lower floor to 0.1 and lower max to 0.3**	

General feedback on the report by the ESAs on the review of the prudential framework and medium-term considerations

Broader review of the securitisation bank capital regime

We welcome that in its recent report on the review of the prudential framework for securitisation, the EBA does recognise there could be merit in rethinking the formulation behind securitisation risk weights if this is done at the Basel level[6]. The EBA identifies medium to long term considerations relating to the formula-based approaches in section 3.3.2 of its report. AFME is of the view that work on the considerations set out by the

[5] Indeed, although the OF applies to the whole Group, in case it becomes binding, Groups would likely compute the OF at transaction-level to determine the "contribution to the OF" of each transaction and whether such transactions are cost-effective or not.

[6] As noted in the report, "…the EBA takes note that it is possible to increase the risk sensitivity of the framework, but this would require a more fundamental and comprehensive review before conclusive opinions can be formed. Moreover, the EBA supports to bring these considerations to the Basel Committee of Banking Supervision (BCBS) as appropriate." (page 8).

EBA (and other considerations such as those relating to the LCR, noted below) should be pursued as a matter of priority following an adoption of the proposed temporary adjustments in the CRR3.

Liquidity Coverage Ratio (LCR)

A separate but important element of the bank prudential framework that AFME supports is improving the treatment of STS securitisations in the LCR, a suggestion which is supported by evidence[7]. This would enable bank treasuries to better access diversified liquidity through more equitable regulatory treatment of the asset class. Combining the punitive capital treatment of securitisation and relatively onerous STS compliance checks with the disproportionate LCR treatment for securitisation relative to other asset classes, bank treasuries remain disincentivised from including the most senior and well rated tranches within their liquid asset buffers. As the ratings migration and loss data shows, these tranches are equivalent or less risky than many fixed income asset classes that enjoy better treatment in both LCR and bank capital frameworks.

AFME sees much room for discussion regarding the conclusions put forward by the ESAs in their response to the Commission Call for Advice in this area[8]. These conclusions fall short of understanding how regulatory requirements – in this case, inferior liquidity treatment for securitisation in the LCR compared to other asset classes – have fundamentally shaped banks' investment incentives and risk-return analysis in this area. We encourage the Commission and the ESAs to pursue direct bilateral engagement with bank treasury departments to truly understand asset allocation drivers and views on the liquidity performance of liquid STS securitisations. We also encourage further consideration of the evidence and market analysis – for instance, studies illustrating that the liquidity performance of European securitisations is comparable, and in cases superior to that of asset classes receiving a better treatment in the LCR.

Solvency 2

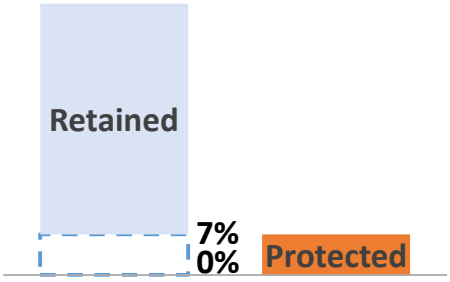
In line with our comments on the bank capital treatment, re-calibrating the risk-weights associated with securitisation investments by insurance companies under Solvency 2 is equally important. Recent academic work suggests that the risks associated with investments in STS securitisation are lower than the risk weights accorded to such investments by insurers. The risk weights should therefore be adjusted to reflect the risk of securitisation investments.

[7] See analysis by Risk Control Limited, commissioned by AFME, "A comparison of ABS and Covered Bond Liquidity" (February 2022) – available on AFME's website.

[8] The ESAs consider that the current framework should be kept as it currently stands. According to supervisory data, credit institutions do not rely on securitisations to face liquidity stress periods. Moreover, there is no new evidence in terms of the performance under a liquidity coverage ratio (LCR) stressed scenario, including the period covering the COVID-19 pandemic, to justify any prudent recalibration of the LCR.

Annex 1: Impact of the output floor on the efficiency on STS and non-STS transactions

We can consider a synthetic securitisation structure where the bank buys credit protection on the first loss with an attachment/detachment point of 0%/7%:



The underlying portfolio ("pool 1") has the following characteristics:

- Number of loans: 400
- Probability of default: 0.5%
- Loss Given Default: 40%
- Maturity: 2.5 years

BEFORE SECURITIZATION:

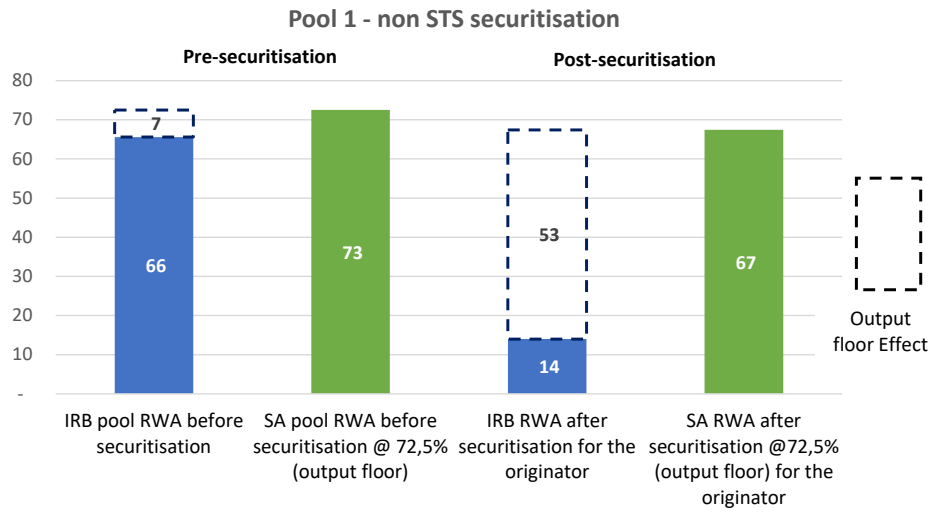
- The IRBA RW of the portfolio is 66%
- The SA RW being 100%, the output floor would be biting: 72.5 – 66 = 6.5pp

AFTER SECURITIZATION:

- The retained senior tranche (93%-thick tranche) would receive a 15% RW under SEC-IRBA (application of the 15% floor): this tranche would thus attract 14 RWA (=93% * 15%).
- To be noted, the protection covers 1.3 time the sum of the Expected Loss (EL) and the Unexpected Loss (UL), making the retained tranche virtually risk-free.
- However, the application of the output floor on the same tranche would be very penalizing: the RW on the retained senior tranche is 100% using SEC-SA i.e. a 72.5% RW floor and thus 67 RWA (=100% * 72.5% * 93%).

Although most of the risk is transferred outside the bank, the efficiency of the transaction after the application of the output floor is considerably reduced:

- Before the application of the Basel III output floor, the transaction would have released 52 RWA (=66 RWA on the pool under IRBA – 14 RWA on the retained senior tranche using SEC-IRBA).
- After application of the floor, the transaction would merely release 6 RWA (=73 RWA on the pool under SA – 67 RWA on the retained senior tranche using SEC-SA). In other words, the efficiency of the transaction is reduced by nearly 90%.

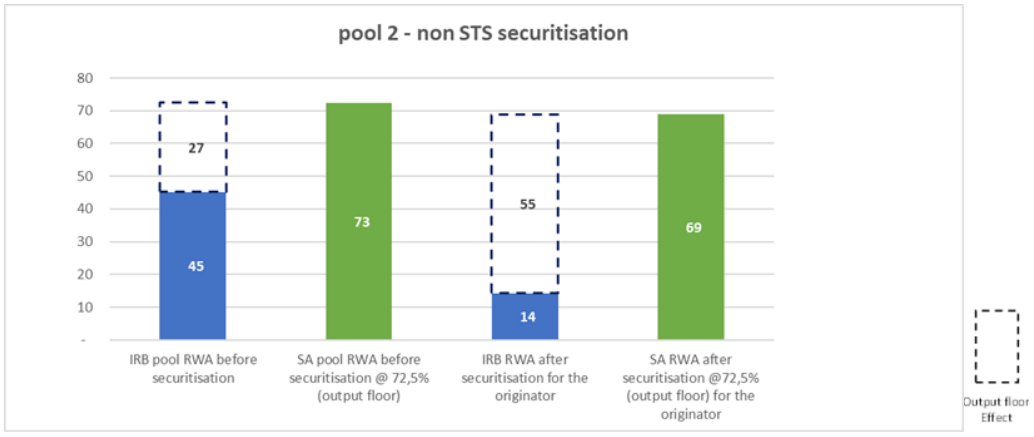


Similar examples could be provided for non-STS and STS transactions:

Non-STS transactions

Portfolio 2

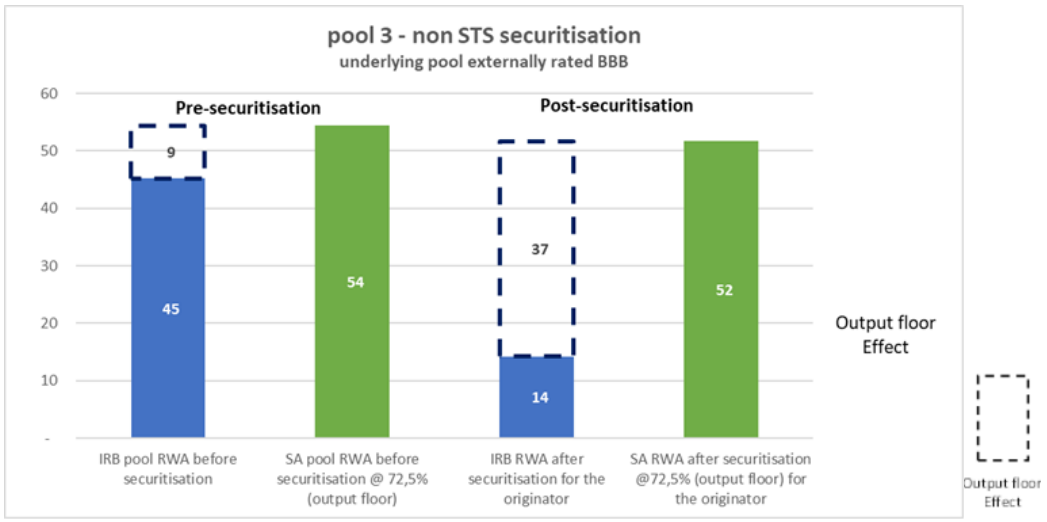
- Average RW: 45.2%
- Granularity: 1,000
- Average LGD: 40%
- Maturity: 5
- Average PD: 0.10%
- UL of the pool: 3.62%
- EL of the pool: 0.04%
- Pool Average RW under SA: 100%



Portfolio 3

- Average RW: 45.2%
- Granularity: 1,000
- Average LGD: 40%
- Maturity: 5
- Average PD: 0.10%

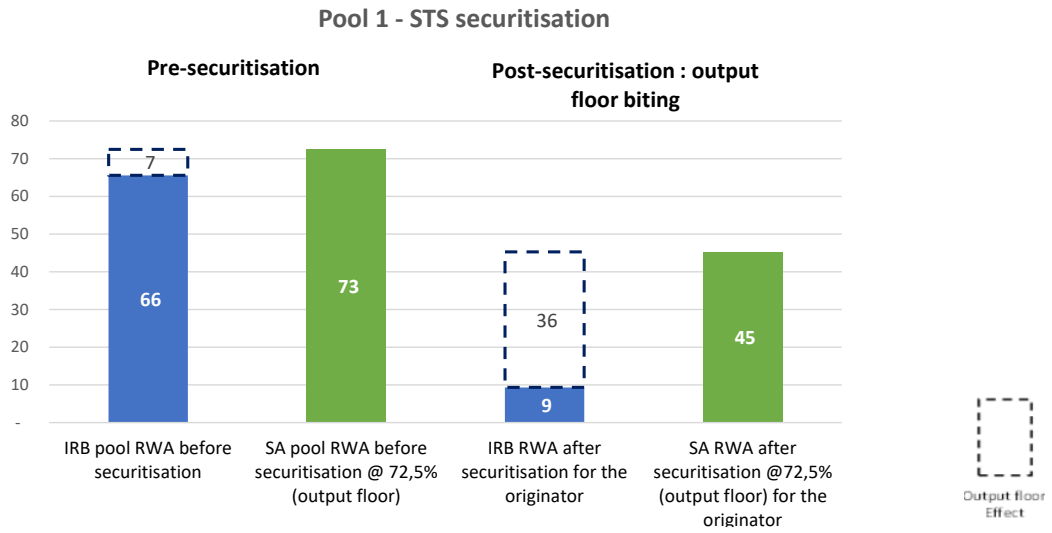
- UL of the pool: 3.62%
- EL of the pool: 0.04%
- Pool Average RW under SA: 75%

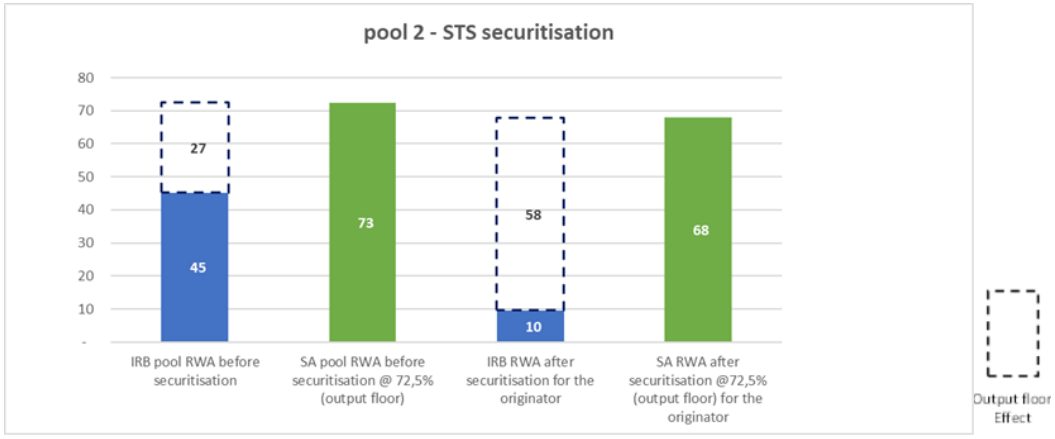


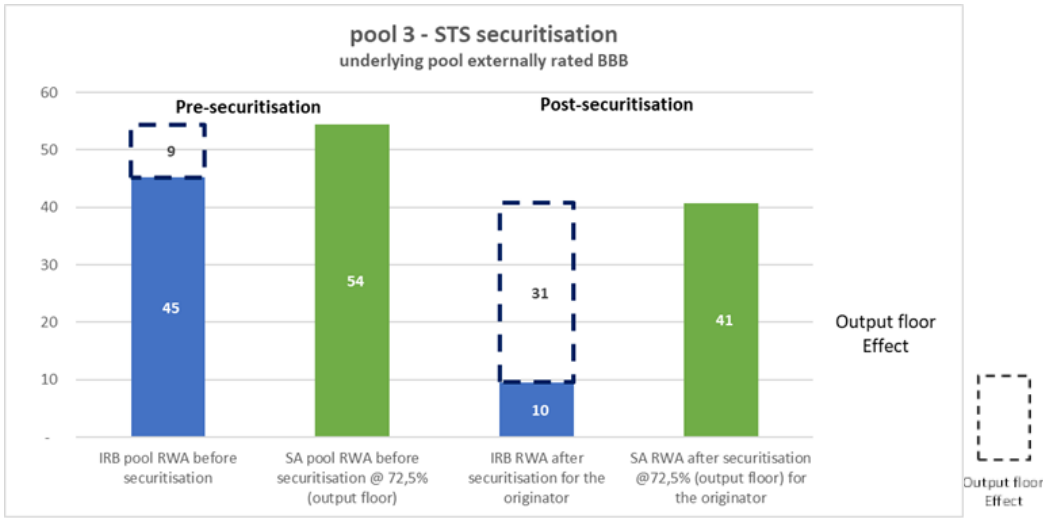
To be noted, the output floor is not biting, and the contribution to the output floor of the SA is reduced when the output floor is not biting pre-securitisation.

STS transactions

Using the same 3 portfolios as above, but that the securitisation transactions qualify for the STS label, the impacts of the output floor are as follows:

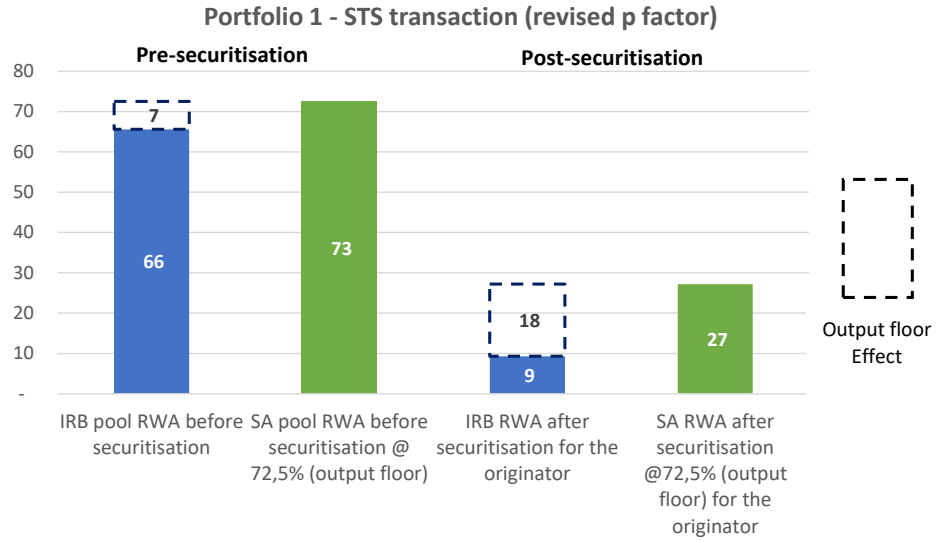






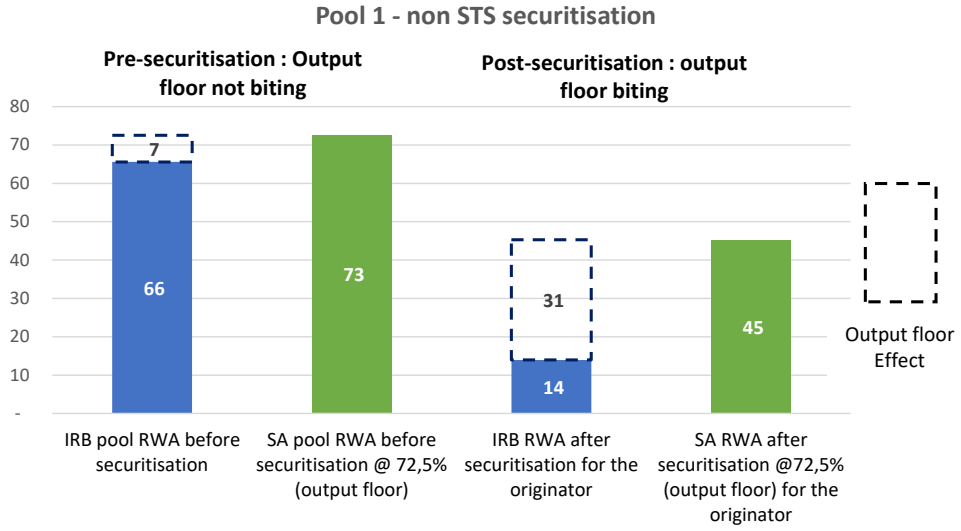
Partial mitigation of the consequences of the output floor thanks to a recalibration of the p factor

Taking the example of the first portfolio, let's consider the impact of a lower "p" factor under SEC-SA (from 0.5 to 0.25) for an STS transaction:



- Such a recalibration would reduce the output floor impact by nearly half.

This time, still taking the example of the first portfolio, let's consider the impact of a lower "p" factor under SEC-SA (from 1 to 0.5) for a non-STS transaction:



- Such a recalibration would reduce the output floor effect by 44%.

Interaction between the output floor and securitisation transactions

Below are two examples on the way securitisation would interact with the global output floor calculation. The assumptions are the same as for portfolio 1 (non-STS transaction), below for convenience

The underlying portfolio ("pool 1") has the following characteristics:

- Number of loans: 400
- Probability of default: 0.5%
- Loss Given Default: 40%
- Maturity: 2.5 years
- The IRBA RW of the portfolio is 66%
- The SA RW being 100%,

In the first case, the output floor is a binding constraint for the bank before securitisation: post-output floor RWA are greater (1,100) than pre-output floor RWA (1,000). In the second case, the output floor is not a binding constraint before securitisation (1,120 RWA before output floor v. 1,100 RWA after output floor).

As one can see, in both cases, the marginal impact of the securitisation under the SEC-SA will almost eliminate any interest of securitizing the portfolio because the effect of the securitisation is very limited on the bank's ratio post output floor, while a significant amount of risk has been transferred:

	Case 1 : Output floor biting before securitisation		
CET 1 capital	**120**	**120**	

	Bank's RWA before O/F	Output floor @ 72,5%	additional RWAs due to O/F
Asset under SA	250	181	
Assets under Internal Model	750	919	
Bank's total RWA before securitisation	1,000	1,100	100
Pool's RWA relief	- 66	- 73	
Tranches retained	14	67	
RWA bank after securitisation	948	1,094	146

	before O/F	after O/F	Gap output floor
Bank's CET1 ratio before securitisation	**12.0%**	**10.9%**	**-1.1%**
Bank's CET1 ratio after securitisation	**12.7%**	**11.0%**	**-1.7%**

	Case 2 : Output floor not biting before securitisation		
CET 1 capital	**120**	**120**	

	Bank's RWA before O/F	Output floor @ 72,5%	additional RWAs
Asset under SA	250	181	
Assets under Internal Model	870	919	
Bank's total RWA before securitisation	1,120	1,100	-
Pool's RWA relief	- 66	- 73	
Tranches retained	14	67	
RWA bank after securitisation	1,068	1,094	26

	before O/F	after O/F	Gap output floor
Bank's CET1 ratio before securitisation	**10.7%**	**10.9%**	**0.2%**
Bank's CET1 ratio after securitisation	**11.2%**	**11.0%**	**-0.3%**

Annex 2: EU Securitisation Regulation: Key Areas of Super-Equivalence (Gold-Plating) to Basel Framework[9]

SECURITISATION REGULATION – GENERAL REQUIREMENTS (NON-STS/STC)

Risk retention

The EU risk retention requirement broadly requires eligible sell-side parties to retain a material net economic interest of 5% in line with prescriptive operational mechanics (which are adjusted for NPE securitisations), and requirements for originator-retainer substance. This requirement does not have a parallel at Basel level, other than in relation to STC transactions. Even for STC transactions, where retention by eligible sell-side parties of a "*material net economic exposure*" is required, no specific retention threshold applies at Basel level (i.e. the retention need not be 5%).

Prohibition on re-securitisation

EU provisions relating to the adverse prudential treatment of re-securitisations derive from Basel, however, the EU *prohibition* (subject to limited exceptions) on re-securitisation, does not have a Basel parallel, other than in relation to STC transactions.

Transparency and reporting

EU transparency and reporting requirements, impose highly detailed, and prescriptive, initial and ongoing, data and documentary disclosure obligations on sell–side parties, including disclosure of all transaction documents essential to understand the deal, template-based loan-by-loan reporting for all (non-ABCP) securitisations, template-based investor and ad hoc event-driven reporting, template-based EU STS notification reporting (if applicable) and (except in 'private' transactions) mandatory publication of all such information and reporting via EU-authorised securitisation repositories. In particular for private transactions (including third country transactions), this level of prescription is not fit for purpose, extremely burdensome and has little use by investors who generally negotiate bespoke reporting requirements. This has no parallel at Basel level, other than in relation to STC transactions. Even in relation to STC transactions, mandatory transparency/disclosure requirements are, by comparison, very limited, and non-prescriptive as to format. In particular, in Basel STC transactions, loan-level data disclosure is replaced with disclosure of "*summary stratification data*" for "*sufficiently granular pools*".

Due diligence

EU institutional investor due diligence requirements provide that, broadly, such investors, prior to investing, must verify certain matters, including compliance by sell-side parties[10] with risk retention, disclosure, credit-granting and, if applicable, STS notification. This has no parallel in Basel. The EU also requires institutional investors to, broadly, obtain, via due diligence, a "*comprehensive and thorough understanding of the securitisation position*", and imposes related ongoing requirements around monitoring, stress-testing, and internal reporting (including a requirement for written policies and procedures). These requirements have a parallel in Basel, however, the equivalent Basel due diligence requirements are a comparatively light touch: for example, only five indicative data points ("as appropriate") are identified at Basel level in relation to due

[9] Analysis prepared by Allen & Overy.
[10] Which is adjusted in certain cases for third country deals

diligence on underlying asset pools, and six indicative data points are identified in relation to due diligence on the structural features of the securitisation.

Credit-granting standards

EU credit–granting requirements broadly require sell-side parties (with some relaxation for NPE securitisations) to apply the same sound and well-defined criteria to exposures to be securitised as to their non-securitised exposures. This requirement does not have a parallel at Basel level, other than in relation to STC transactions. In relation to performing purchased receivables, the EU credit–granting standards are more onerous even than the STC requirements at Basel level[11].

Prohibition on securitisation of self-certified residential loans

The EU prohibition (subject to limited exceptions) on securitisation on self-certified residential loans has no parallel at Basel level.

Adverse selection

The EU adverse selection restriction broadly prohibits originators (in the absence of appropriate disclosure) from selecting assets for transfer to SSPEs with the aim of rendering losses on transferred assets higher than losses on comparable assets retained. This does not have a parallel at Basel level other than in relation to STC transactions, where 'cherry picking' by originators is prohibited.

SSPE requirements

The EU prohibits establishment of SSPEs in third countries blacklisted by the EU for tax or anti-money laundering and counter terrorism financing purposes (AML/CTF). The EU also imposes a tax authority notification requirement for investors when investing in securitisations involving third country SSPEs established in jurisdictions where the EU identified certain shortcomings in relation to the implementation of transparency and reporting for tax purposes. This restriction has no parallel at Basel level.

Sale to retail

The EU prohibits the sale of securitisation positions to EU MiFID retail clients unless specified conditions and, for portfolios ≤ EUR 500,000, specified investment limits, are complied with. This restriction has no parallel at Basel level.

CRR SECURITISATION PRUDENTIAL REGULATION – SIGNIFICANT RISK TRANSFER (SRT) REQUIREMENTS

Quantitative SRT Assessment

Basel imposes a high-level requirement for "*significant credit risk associated with the underlying exposures*" to be transferred "*to third parties*" (in which context, no threshold level for "*significance*" is specified). In the EU, this requirement is implemented via an extensive, prescriptive and conservative, stress-testing and lifetime modelling regime encompassing broader concepts of "*commensurateness*".

[11] The receivable seller's standards do not have to match the standards of the securitisation sell-side parties

In addition to imposing tests relating to the quantum of risk transfer, as required by Basel (the CRR first loss test/mezzanine test, and proposed PBA test), the EU tests assess:

- the "*commensurateness*" of the risk transfer to the capital reduction achieved (an assessment currently made by NCAs, but proposed to be formalised and standardised in the CRT test),

- the sufficiency of tranche thickness (an assessment currently made by NCAs, but proposed to be formalised and standardised in a minimum thickness requirement in the CRR first loss test), and

- the sustainability of the risk transfer over the life of the transaction, with proposed mandatory modelling, in specified extreme stress scenarios, of transaction-specific features including time calls, amortisation structure and excess spread expectations.

In the context of the above tests, EU originators are also proposed to be required, with no explicit Basel parallel, to reflect excess spread as a retained first loss tranche, save that originators of traditional securitisations can avoid this treatment where a 'market test', relating to pricing, is passed.

Tests for High-Cost Credit Protection

General principles relating to the cost of protection in credit risk mitigation identified in 2011 Basel guidance (not forming part of the comprehensive Basel framework)[12], are proposed to be reflected, in the EU, in a series of binding (and conservative) quantitative tests, failure to pass *all* of which results in an on-balance sheet securitisation failing to qualify for SRT.

Mandatory Performance-Related Triggers to Revert to Sequential Amortisation

SRT transactions featuring non-sequential amortisation are subject to prescriptive mandatory performance-related triggers to switch to sequential amortisation (currently an NCA practice (save for STS transactions, where such triggers already exist), but proposed to be formalised and standardised), this has no explicit Basel parallel, other than in relation to STC transactions. Even in relation to STC transactions, specific performance-related triggers are prescribed only for transactions featuring replenishment.

CRR SECURITISATION PRUDENTIAL REGULATION – OTHER KEY AREAS[13]

Risk Weighting of Synthetic Excess Spread

EU originators of on-balance sheet securitisations are, in the EU, required, with no explicit Basel parallel, to risk weight excess spread as a retained first loss tranche (with conservative and complex calculation mechanics to establish the exposure value and adverse economic implications for transaction types, such as SME and consumer lending deals, that typically involve excess spread).

[12] https://www.bis.org/publ/bcbs_nl16.htmhttps://www.bis.org/publ/bcbs_nl16.htm

[13] **Please note that this analysis covers the securitisation framework, itself, only and not related areas of prudential regulation, including but not limited to the credit risk mitigation framework (which is relevant to on-balance sheet securitisations).**

Use of the Purchased Receivables Approach to K_{IRB}

The EU is more prescriptive than Basel about the circumstances in which the purchased receivables approach to the calculation of K_{IRB} can, and cannot, be used, it also imposes an internal model approval requirement in relation to the use of this approach, and more onerous fall-back LGD mechanics that does not allow for the recognition of collateral.

Weighted Average Maturity (WAM) calculation

The EU imposes prescriptive, complex and conservative calculation mechanics, involving asset and liability modelling, to calculate WAM for purposes of the maturity input to the SEC–IRBA and SEC–ERBA formulae. This has no Basel parallel (though Basel is more conservative in relation to the availability of WAM-based maturity (rather than final legal maturity)).

LCR

This analysis generally addresses the securitisation requirements of the credit risk framework, however, we make one observation, in passing, in relation to the treatment of securitisation as HQLA in the LCR. It is well-known that the EU LCR permits a somewhat wider range of securitisation collateral types to qualify as HQLA than does Basel. However, the EU HQLA requirements for ABS also gold-plate Basel in certain respects (including for RMBS, which Basel envisages as HQLA). Notably, the EU requires eligible ABS to:

- benefit from, broadly, a AAA rating rather than the AA rating permitted by Basel,
- be STS compliant (thus incorporating by reference a very large number of additional eligibility criteria, by contrast, Basel does not require STC eligibility)
- have a ≥5 year residual weighted average life).

EU SECURITISATION TRADITIONAL[14] STS REQUIREMENTS (NON-ABCP) AND BASEL STC REQUIREMENTS (NON-ABCP)

True sale, asset isolation, absence of severe "claw back" provisions, perfection events, no asset encumbrance affecting true sale

The EU and Basel provisions are broadly similar, but the EU requirements are more prescriptive and expressly require a true sale legal opinion.

Homogeneity of underlying exposures, periodic payment streams, no transferable securities.

Some starting points for these requirements are broadly similar. However, the EU is far more prescriptive, the EU expressly excludes transferable securities, confirms for periodic payment streams that underlying exposures may also generate proceeds from the sale of any financed or leased assets and provides for more granular rules on homogeneity factors via the corresponding technical standards.

Eligible underlying assets, including underwriting standards, assessment of retail borrower' creditworthiness

[14] We note that the EU provides a separate STS framework for on-balance sheet (synthetic) securitisations

The EU has more prescriptive requirements, as well as certain additional requirements, for the purposes of these criteria. These include requirements specific to certain asset classes (eg residential mortgage loans); requirements for the application of post-closing eligibility criteria; a requirement for the originator to have expertise in originating exposures (which must be disclosed to investors in sufficient detail in accordance with applicable confidentiality requirements); requirements for disclosure of material changes from prior underwriting standards; and equivalence requirements for the assessment of the creditworthiness of borrowers in third countries.

No active portfolio management

The EU has more prescriptive parameters for what may constitute active portfolio management, which effectively exclude managed CLOs.

At least one payment made

The EU requires that at least one payment should have been made by each underlying borrower, at the time of the transfer, in order to reduce the likelihood of the loan being subject to fraud of operational issues. There are no similar requirements in Basel.

No re-securitisation

Broadly similar restrictions on no re-securitisation apply in the EU and under Basel. However, the EU anticipates, by way of derogation, to permit re-securitisation in certain cases. To date, no guidance or rules have been introduced in the EU to further specify the cases when this might be permitted.

Appropriate mitigation of interest rate and currency risks, only hedging is permitted and no other derivatives

Broadly similar requirements apply in the EU and under Basel, but the EU requirements are more prescriptive, they require appropriate disclosure, and include a requirement for sufficient creditworthiness of the counterparty and, failing which, a requirement for collateralisation, replacement or guarantee by another counterparty.

Absence of credit-impaired obligors and loans in default

Some Basel and EU provisions are similar, but the EU requirements are much more prescriptive, they extend to the guarantors of the debtors, prescribe "best knowledge" standards and set parameters for debtors or guarantors that have undergone a debt-restructuring process.

Remedies and actions related to delinquency and default of a debtor

The EU is more prescriptive and requires, in addition, disclosure to investors (without undue delay) of any change in priorities of payment that materially adversely affect the repayment of the securitisation.

Continuity/replacement of counterparties

The EU and Basel provisions are broadly similar.

Restriction on reliance, for repayment, on future sale of assets

Similar restrictions apply in the EU and under Basel, but the EU frames the requirement as an absence of "predominant reliance" on the sale of assets (which does not prevent roll-over or refinancing of the assets subject to prescribed parameters/conditions).

Pass-through requirement, priorities of payment, early amortisation provisions and triggers for termination of the revolving period, restriction on cash trapping in certain scenarios

The EU requirements are more prescriptive. The EU also include provisions and sets out parameters for SSPE cash trapping and provisions relating to non-sequential priority of payments, which are not provided for in Basel.

Interest rate formulation, referenced interest payments

Broadly similar requirements apply in the EU and under Basel.

Resolution of conflicts between different classes of investors, provision of an "identified person" acting in the best interests of investors, voting rights of investors

The EU is more prescriptive and includes specific requirements on there being clear (contractual or statutory) provisions facilitating the timely resolution of conflicts.

Servicer expertise and performance history

The EU is more prescriptive, sets out more granular criteria on the expertise of servicer, including prescribed parameters for deemed compliance (eg five years of servicing exposures of a similar nature to those securitised) and detailed requirements for well-documented and adequate policies, procedures and risk management controls.

Mandatory external asset verification

The EU is more prescriptive as to which independent parties are eligible to carry out such verification, sets out parameters for the scope and confirmation of verification.

Liability cashflow model

The EU provisions are more prescriptive.

Environmental performance of assets, sustainability factor disclosure

Only the EU regime (not Basel) includes requirements relating to environmental performance of the assets (currently limited to residential mortgages and auto loans and leases). This disclosure regime will, in due course, be accompanied by new (yet to be finalised) technical standards on template-based reporting on the sustainability factor.

Transparency and reporting and disclosure of historical performance data

The EU prescribes, more specifically, reporting on historical performance covering at least five years. Basel simply refers to a "time period long enough".

In addition, the EU imposes prescriptive, initial and ongoing, transparency and reporting requirements in relation to data and documentary disclosure obligations on sell–side parties, including disclosure of all transaction documents essential to understand the deal, template-based (in xml format) loan-by-loan reporting for all (non-ABCP) securitisations, template-based investor and ad hoc event-driven reporting, as well as disclosure of template-based STS notification and (except in 'private' transactions) mandatory publication of all such information and reporting via EU-authorised securitisation repositories. By contrast, at Basel level, mandatory transparency/disclosure requirements are, in comparison, very limited, and non-prescriptive as to format. In particular, in Basel, loan-level data disclosure is replaced with disclosure of "*summary stratification data*" for "*sufficiently granular pools*".

Risk retention

The EU risk retention requirement broadly requires eligible sell-side parties to retain a material net economic interest of 5% in line with prescriptive operational mechanics, and requirements for originator-retainer substance. The Basel provisions are less prescriptive and do not provide for any specific retention threshold (i.e. the retention need not be 5%).

Maximum collateral risk weights for STS prudential treatment

Broadly similar requirements apply in the EU and under Basel though certain definitions used at Basel level have yet to be implemented in the EU (under CRR3)).

Collateral granularity requirements for STS prudential treatment

The EU granularity requirements make use of a concessionary 2% concentration limit envisaged in Basel (Basel generally requires a 1% concentration limit), but extends it to all transactions (Basel limits the concessionary concentration limit to transactions, with corporate exposure collateral, in jurisdictions with structurally concentrated corporate loan markets, and subject to ex ante supervisory approval, where the originator or sponsor retains subordinated tranche(s) (not themselves eligible for STC) that absorb the first ≥10% of losses).

RRE LTV requirements for STS prudential treatment

The EU imposes a 100% LTV cap for RRE exposures in STS securitisations. There is no Basel equivalent to this requirement.

Requirements relating to prior ranking security rights over RRE and CRE for STS prudential treatment

The EU imposes a requirement for loans with lower ranking security rights over RRE or CRE to be included in collateral pools only where all prior ranking security rights are also included in the pool. There is no Basel equivalent to this requirement.