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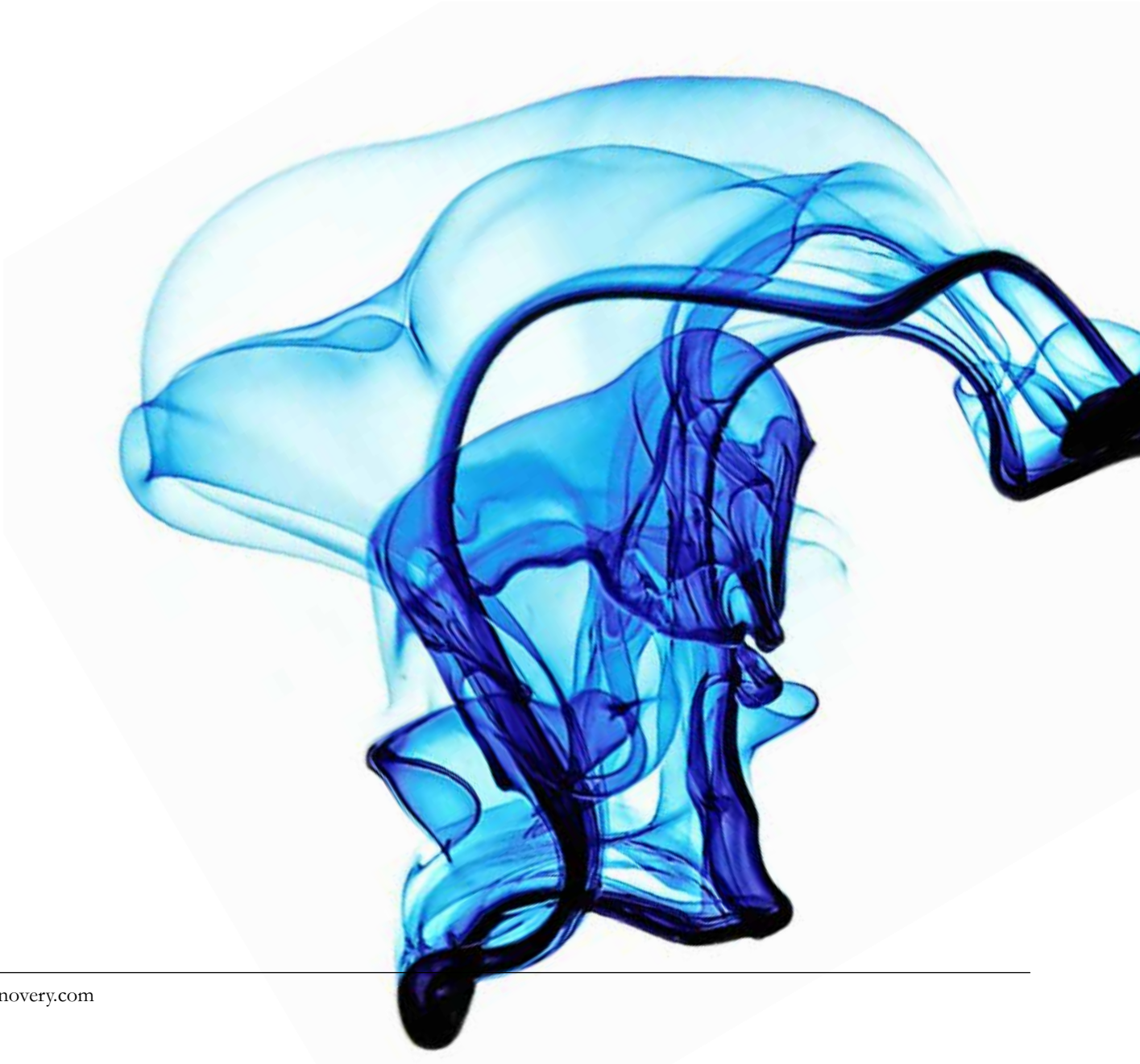
PRA consultation paper published on the revised EU securitisation framework and significant risk transfer

June 2018



Introduction and background

On 22 May 2018, the UK Prudential Regulatory Authority (**PRA**) published a consultation paper (linked *here*) setting out its proposed approach to implementing certain matters related to the coming EU Securitisation Regulation[1] and revised securitisation capital framework under the amended EU Capital Requirements Regulation[2] (**CRR**), as well as certain updated expectations on the part of the PRA with regard to significant risk transfer (**SRT**) securitisation.

The PRA's proposals in relation to SRT (in particular its proposals re (i) excess spread, and (ii) the assessment of commensurate risk transfer for portfolios of exposures on the standardised approach to credit risk) represent material contributions to a current European debate around reforms to the SRT regime proposed in the EBA's Discussion Paper on Significant Risk Transfer (linked *here*, the **EBA SRT DP**). As such, they may be of interest to firms outside the scope of UK prudential regulation that participate in SRT securitisations, their regulators, and, potentially, the EBA in finalising its response to the EBA SRT DP (the EBA has until January 2021 to report back) and any resulting delegated regulation.

The PRA's proposals in relation to the revised CRR securitisation capital framework (specifically, its approach to the exercise of discretions to restrict the use of formulae-based risk weighting approaches under the new CRR hierarchy where it has concerns that they do not reflect inherent non-credit risks in transactions, or to mitigate perceived financial stability issues) are also significant. However, it remains to be seen whether the PRA's approach (if confirmed) will influence other European regulators in this respect, or (like PRA restrictions, in practice, around the use of the supervisory formula method (**SFM**) in the current risk weighting hierarchy) remain UK specific 'gold-plating'.

This briefing provides a summary of the proposals set out in the consultation paper by addressing the key matters covered in the paper with respect to each of the Securitisation Regulation, the CRR securitisation capital framework and SRT, and taking each topic in turn. We encourage interested clients to contact us with any questions.

01_Regulation (EU) 2017/2402

02_Regulation (EU) No 575/2013

Securitisation regulation

Overview and application

As an EU regulation, it is not necessary for the UK authorities to implement the Securitisation Regulation in general and this is reflected in the PRA consultation paper as it focuses only on certain specific matters related to the requirement on national competent authorities to regularly review the arrangements, processes and mechanisms that relevant entities have put in place in order to comply with the Securitisation Regulation. In particular, the consultation paper seeks to clarify the PRA's approach and expectations in relation to (i) chapter 2 of the Securitisation Regulation, which provides for certain requirements for originators, sponsors, original lenders, securitisation special purpose entities (**SSPEs**) and institutional investors in respect of new securitisations in general from the start of 2019 and (ii) firms that intend to sponsor simple, transparent and standardised (**STS**) asset backed commercial paper programmes in accordance with the new STS regime provided for by the Securitisation Regulation.

The consultation paper proposals are described to be relevant to all PRA-authorised firms subject to the CRR and Capital Requirements Directive IV[3] (together **CRD IV**) and all Solvency II[4] firms. We understand that the UK Financial Conduct Authority (**FCA**) is likely to publish a consultation paper setting out certain expectations for those firms that it supervises in connection with the Securitisation Regulation later this year. However, given the similarity, in general, of PRA and FCA guidance where it relates to the same legislation, the consultation paper is likely to be of interest to FCA-authorised CRD IV firms. The PRA consultation paper acknowledges that a securitisation may involve different entities that are prudentially supervised by different UK competent authorities and indicates that the PRA, FCA and The Pensions Regulator will need to share information and co-operate in order to discharge their relevant functions under the Securitisation Regulation.

With respect to the general requirements set out in chapter 2 of the Securitisation Regulation, the consultation paper refers to the key points set out in the following pages.

03_https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:02013L0036-20180113 (but please use a link where this link is accessed by clicking on the words "Capital Requirements Directive IV")

04_The Solvency II Directive (2009/138/EC) and the Solvency II Delegated Regulation (2015/35), jointly 'Solvency II'

Originators, sponsors and original lenders in general

– Firms that act as originators, original lenders or sponsors in a securitisation who are subject to the requirements of the Securitisation Regulation should be able to demonstrate to the PRA that they have adequate arrangements, processes and mechanisms to comply with article 6 (risk retention and adverse selection), article 7 (transparency), article 8 (ban on re-securitisation) and article 9 (credit granting standards) of that Regulation. The firm's internal audit function should provide assurance as to compliance with the requirements under those articles.

– Further, individuals performing senior management functions (**SMFs**) should exercise effective oversight of securitisation issuances (specifically including the rules in article 6(2) of the Securitisation Regulation on adverse selection of assets). An SMF should escalate issues related to oversight of securitisation issuance to the management board or relevant sub-committee.

– Material changes in securitisation activity should be notified by a firm to its supervisor. For example, a notification should be made in respect of first time securitisers, firms securitising a new asset class for the first time and significant increases in issuance amounts.

Insurance firms, reinsurance firms or insurance special purpose vehicles (*ISPVs*) as originators

– Insurance and reinsurance firms and ISPVs should consider whether transactions entered into to refinance loans, exposures or receivables (including any internal restructurings) give rise to a securitisation and consider whether the entity's involvement triggers the originator and/or investor obligations.

– Where an insurance or reinsurance firm is an originator in respect of a securitisation, that firm should comply with the originator requirements set out in articles 6, 7, 8 and 9 of the Securitisation Regulation as applicable. If an insurance or reinsurance firm or ISPV identifies itself as the originator of a securitisation, it should inform its supervisor without undue delay.

– Where the originator is also the sole investor in the transaction, the firm may consider the article 7(1)(a) and (e) disclosure and reporting obligations satisfied through certain internal reporting steps being taken to appropriate committees or the management board, provided the reporting contains the required information. (We note that it is not entirely clear whether this provision is intended to apply in respect of originator firms in general, or just in respect of insurance or reinsurance firms.)

Investors

– Institutional investors which invest in securitisation should be able to demonstrate that they have in place adequate due diligence arrangements, processes and mechanisms to ensure compliance with article 5 (due diligence) of the Securitisation Regulation.

– A firm that has delegated the authority to manage its investments to another institutional investor may instead evidence that it has instructed the managing party to fulfil the due diligence requirements on its behalf.

With respect to firms that intend to sponsor STS asset backed commercial paper programmes in accordance with the new STS regime, it is proposed in the consultation paper that a PRA-authorised CRD IV credit institution may act as such a sponsor using one of the following routes based on article 25(3) of the Securitisation Regulation:

– article 25(3), subparagraph 1 – the credit institution demonstrates to its competent authority that the support it provides to the programme would not endanger its solvency and liquidity, even in an extreme market stress. This can be demonstrated through providing relevant information that should include: (i) an assessment of the impact of full support on the firm's Total Capital Requirement on an individual and consolidated basis, both with and without STS status; (ii) an assessment of the impact of full support on the firm's regulatory liquidity guidance and buffer resources, both with and without STS status; and (iii) a summary of the programme features relevant to an understanding of the assessment in (i) and (ii) above, including an assessment against STS requirements in articles 25 and 26 of the Securitisation Regulation; or

– article 25(3), subparagraph 2 – the competent authority has determined on the basis of the review and evaluation referred to in Article 97(3) of CRD IV that the arrangements, strategies, processes and mechanisms implemented by that credit institution and the own funds and liquidity it holds ensure the sound management and coverage of its risks. This can only be done if the firm is currently a sponsor for at least one ABCP programme. This may include any existing non-STS ABCP programme for which the firm wishes to seek STS status. The firm will have to make a written request to its usual supervisory contact prior to or alongside the submission of either its internal capital adequacy assessment process (**ICAAP**) or internal liquidity adequacy assessment process (**ILAAP**) document.

The PRA will be the competent authority for the purposes of article 25(3) of the Securitisation Regulation with respect to PRA-authorised CRD IV credit institutions.

Revised CRR securitisation capital framework

Overview and application

The PRA proposals on the revised CRR securitisation capital framework relate to (i) the hierarchy of methods used to calculate risk weighted exposure amounts (**RWEAs**) for securitisation positions and (ii) the interim mapping of External Credit Assessment Institutions (**ECAIs**)' structured finance credit assessments to Credit Quality Steps (**CQS**) with respect to the interim mapping of rating agency grades to CQS for the purposes of securitisation positions risk weighted under the SEC-ERBA (as defined below).

The proposals are described to be relevant to all PRA-authorised CRD IV firms. However, given the similarity, in general, of PRA and FCA guidance where it relates to the same legislation, the consultation paper is likely to be of interest to FCA-authorised CRD IV firms.

The PRA does not make any proposals regarding the Solvency II securitisation capital framework, but indicates that it may decide these are needed once amendments to the Solvency II Delegated Regulation[5] related to a new calibration for STS securitisations have been agreed and adopted into the Official Journal of the European Union. In this regard, we note that the relevant amendments were adopted by the EU Commission last week.[6]

As indicated below, in relation to the hierarchy of methods used to calculate RWEAs for securitisation positions, the PRA proposes – similar to its approach in relation to the SFM under the current securitisation risk weighting hierarchy – to exercise discretions available to it to restrict the use of formulae-based risk weighting approaches under the new CRR hierarchy, where it has concerns that they do not reflect inherent risks in transactions. It remains to be seen whether the PRA's approach (if confirmed) will influence other European regulators in this respect, or (like current restrictions, in practice, around the use of the SFM) represent UK specific 'gold-plating'.

05_Delegated Regulation (EU) 2015/35

06_FN text – http://europa.eu/rapid/midday-express.htm and https://ec.europa.eu/transparency/regdoc/rep/3/2018/EN/C-2018-3302-F1-EN-MAIN-PART-1.PDF

Hierarchy of methods used to calculate RWEAs for securitisation positions

The hierarchy used for calculating RWEAs for securitisation[7] positions under the CRR (which diverges from Basel in prioritising the SEC-SA over the SEC-ERBA subject to certain limitations) can be summarised as follows:

- where the conditions set out in Article 258 CRR are met, the Securitisation Internal Ratings Based Approach (the **SEC-IRBA**) applies, subject to competent authority discretion to preclude the use of the SEC-IRBA on a case by case basis, where securitisations have highly complex or risky features;
- where the SEC-IRBA may not be used, the Securitisation Standardised Approach (the **SEC-SA**) applies, subject to:
  - specified circumstances in Article 254(2)[8] in which firms are required to use the SEC-ERBA instead of the SEC-SA;
  - firm discretion to apply the SEC-ERBA instead of the SEC-SA to all rated positions and positions in respect of which a rating can be inferred; and
  - competent authority discretion to prohibit, on a case by case basis, the use of the SEC-SA when the RWEAs resulting from the application of the SEC-SA are not commensurate with the risks posed to the institution or to financial stability;
- where the SEC-SA may not be used, the Securitisation External Ratings Based Approach (the **SEC-ERBA**) applies for rated positions and positions in respect of which an inferred rating may be used (or the Internal Assessment Approach applied to derive a rating for eligible unrated positions in asset backed commercial paper); and
- where none of the above approaches may be used, a risk weight of 1,250% applies (or the position may, alternatively, be deducted from Common Equity Tier 1 (**CET1**) capital).

Application of the hierarchy is subject to maximum caps set out in Articles 267 and 268 CRR.

The PRA proposes guidance to the effect that, in determining whether to exercise its discretion to preclude the use of the SEC-IRBA and/or SEC-SA, it will consider whether securitisations a firm is exposed to exhibit features which are not explicitly captured in the SEC-SA or SEC-IRBA methods. The PRA may also consider the appropriateness of underlying credit risk weights for the portfolio as reflected in the K_{SA} (broadly, the capital charge determined under the SA for the securitised exposures as if they had not been securitised, $\mathbf{K_{SA}}$) or K_{IRB} (broadly, the capital charge determined under the internal ratings-based approach for the securitised exposures as if they had not been securitised, $\mathbf{K_{IRB}}$) under Article 255. Because the SEC-IRBA is sensitive to a wider range of inputs than the SEC-SA, where the presence of a highly complex or risky feature leads the PRA to exercise its discretion to preclude the use of the SEC-IRBA, it is also likely to prohibit the use of the SEC-SA on the grounds that the risk weights under the SEC-SA are not commensurate to the risks posed to the institution.

07_For a position in a re-securitisation, the SEC-SA must be applied, with the modifications set out in Article 269 CRR

08_(a) where the application of the SEC-SA would result in a risk weight higher than 25% for positions qualifying as positions in an STS securitisation;
(b) where the application of the SEC-SA would result in a risk weight higher than 25% or the application of the SEC-ERBA would result in a risk weight higher than 75% for positions not qualifying as positions in an STS securitisation; (c) for securitisation transactions backed by pools of auto loans, auto leases and equipment leases

The SEC-SA and SEC-IRBA methods only recognise a defined number of items in their calculation of capital requirements, primarily focused on credit risk. They may fail to recognise the presence of non-credit risks. Some additional non-credit risks which can arise from securitisation are reflected in the 'non-neutrality' of the securitisation capital framework (ie the risk weights for tranches in a securitisation will be higher than the risk weighted exposures of the portfolio if it had not been securitised). However, the level of non-neutrality is driven by pre-defined inputs (eg STS status).

It is possible that an appropriate assessment by an ECAI takes into account those features and so the SEC-ERBA may more appropriately reflect the risk posed to the institution. The PRA identifies the following, non-exclusive examples of features not captured in the SEC-SA or SEC IRBA:

– interest rate risks or foreign exchange risks which arise due to mismatches between the underlying pool and the issued notes, and which are not adequately hedged;

– features or characteristics which expose holders of securitisation notes to the risk that market conditions at the date of the sale or refinance of underlying exposures result in losses, such as exposure to residual value risk (nb re residual value risk, that positions in securitisations of auto-loans, auto-leases and equipment leases are, in any case, required by the CRR to be risk weighted using the SEC-ERBA rather than the SEC-SA where a rating/inferred rating is available, and the SEC-IRBA cannot be used);

– portfolios which exhibit a high degree of single name, sectoral or geographical credit concentration risk;

– portfolios where the underlying exposures may be highly correlated in the event of a stress;

– complex mechanisms which impact the priority of payments, for example the existence of turbo features; and

– for transactions to which the SEC-SA applies, where the characteristics of the underlying portfolio exhibit material dilution risk.

Additionally, the PRA may identify financial stability issues not measured by the SEC-SA method and may therefore seek to mitigate the risk.

Understandably, no distinction is drawn between STS and non STS securitisations, notwithstanding the indication in the article 254 (4) CRR basis for competent authority distinction in relation to the SEC-SA, that competent authorities need not consider "highly complex and risky features" in relation to STS securitisations.

If the PRA exercises the discretions outlined above to preclude use of the SEC-SA and, (if relevant) SEC-IRBA unrated positions for which a rating cannot be inferred (or the IAA used) will attract a 1250% risk weighting (or deduction from CET1 capital).

09_When a firm assesses risks associated with exposures to securitisation as part of their ICAAP, firms should consider the following:

(i) The risk characteristics and structural features of a securitisation, including those of the underlying exposures, which could materially impact the performance of any positions in that securitisation held by the firm;

(ii) Whether the application of another method, namely SEC-IRBA, SEC-ERBA or SEC-SA, insofar as that method may be used, would result in material differences in risk weights for a position relative to the method applied; and

(iii) The extent to which differences in risk weights identified in (ii) may be caused by the risk characteristics and structural features identified in (i) as well as the approach taken by an ECAI in rating a particular asset class.

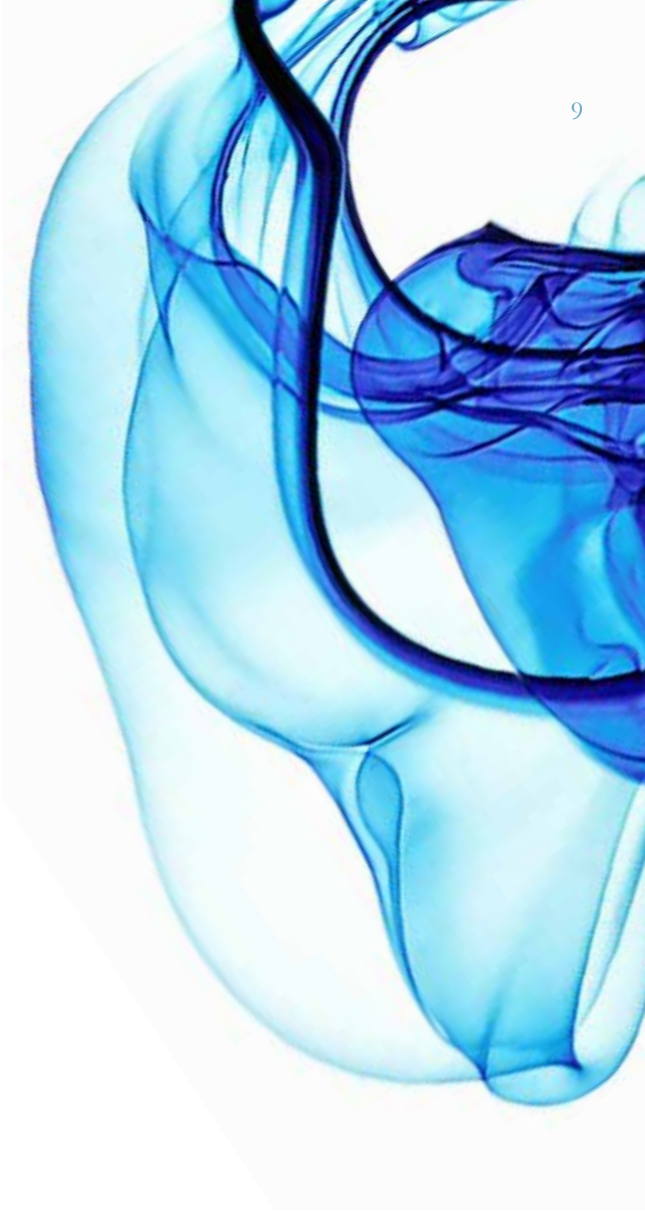
10_A firm's record under Internal Capital Adequacy Assessment of its approach to evaluating and managing securitisation risk (or credit risk arising from securitisation exposures) should cover the following issues as appropriate, taking into account SS9/13 'Securitisations: Significant Risk Transfer':

(i) The appropriateness of the credit risk weight calculated for the asset classes to which the firm is exposed via securitisation;

(ii) Risk characteristics and structural features exhibited by securitisations to which the firm is exposed, that may materially impact the performance of the securitisation position, and are not explicitly taken into account by the method applied;

(iii) The risk weighted exposure amounts for those positions, split by asset class or feature as appropriate, which would be arrived at under the SEC-IRBA, the SEC-ERBA and the SEC-SA insofar as that method may be used; and

(iv) The firm's exposure to unrated securitisation positions.



The PRA will use firms' reporting in the ICAAP document, as well as information received by regulatory reporting and other means, to determine whether securitisation exposures under the SEC-SA or SEC IRBA are appropriately capitalised. Various matters are mandated for consideration[9] and reporting[10] in firms' ICAAPs in relation to their securitisation positions.

The ICAAP requirements potentially involve the calculation of RWEAs under multiple risk weighting methods, identification of risk characteristics and structural features of securitisations not explicitly taken into account in those risk weighting methods, and critical evaluation of ECAI rating methodologies. The PRA may request further information, which must then be provided within 20 business days. The information requested may vary, but certain core information requirements are specified (these are listed in the footnote)[11].

Senior management (ie the individual(s) performing the relevant SMFs) and employees subject to the Certification Regime involved in investment decisions in securitisation exposures (eg relevant Material Risk Takers (**MRTs**) under the Remuneration rules) are required to ensure that a firm uses appropriate methods to capitalise securitisation positions.

Firms choosing to apply the SEC-ERBA instead of the SEC-SA to their rated securitisations, or positions in respect of which an inferred rating may be used, are required to notify the PRA.

11_(i) A list of the securitisation positions to which the SEC-SA or the SEC-IRBA is applied.

(ii) For each securitisation position listed in (i):

– the asset class of the underlying securitised exposures;

– the risk characteristics and structural features exhibited by the securitisation that may materially impact the performance of the firm's securitisation position, and which are not explicitly taken into account by the method applied;

– the risk weights for each securitisation position under the SEC-IRBA, SEC-SA and SEC-ERBA (insofar as each method can be used);

– a hyperlink to the prospectus of the transaction, or where no prospectus is available a copy of the offering circular or equivalent; and

– for rated securitisation positions, the latest rating(s) attributed to the position and the ECAI(s) which provided that rating.

Interim mapping of ECAIs' (rating agencies') structured finance credit assessments to credit quality assessments

The EBA is producing implementing technical standards mapping credit assessments by ECAIs to the credit quality standards specified in CRR. Until these are in place, the PRA proposes that firms use the illustrative Basel securitisation ERBA mapping for long-term ratings and the existing short-term mapping in Commission Implementing Regulation (EU) 2016/1801.

Table 1: Long-term ECAI assessment mapping

CREDIT QUALITY STEP	ILLUSTRATIVE RATING
1	AAA/Aaa
2	AA+/Aa1
3	AA/Aa2
4	AA-/Aa3
5	A+/A1
6	A/A2
7	A-/A3
8	BBB+/Baa1
9	BBB/Baa2
10	BBB-/Baa3
11	BB+/Ba1
12	BB/Ba2
13	BB-/Ba3
14	B+/B1
15	B/B2
16	B-/B3
17	CCC+/CCC/CCC- Caa1/Caa2/Caa3
18	Below CCC-/Caa3

Significant risk transfer

Overview and application

The PRA proposals on SRT relate to:

– excess spread;

– the assessment of commensurate risk transfer for portfolios of exposures on the standardised approach to credit risk (**SA**); and

– senior management engagement in SRT securitisations.

The PRA also clarifies, in line with its obligations under the EBA SRT Guidelines, that as part of reviewing an SRT transaction it may assess the expertise of a chosen credit rating agency in the asset class used as collateral for the securitisation positions being rated.

The CP does not address all transaction features discussed in the EBA SRT DP and the PRA indicates that it will continue to develop its views in relation to these.

The proposed changes in relation to SRT are described to be relevant to all PRA-authorised CRD IV firms. However, given the similarity, in general, of PRA and FCA guidance where it relates to the same legislation, the consultation paper is likely to be of interest to FCA-authorised CRD IV firms and potentially also to FCA-authorised BIPRU firms.

It remains to be seen whether the PRA's approach in relation to SRT (if confirmed) will influence other European regulators, and/or the EBA in finalising its response to the EBA SRT DP, or whether it will increase the (currently significant) UK specific 'gold-plating' in relation to SRT. The consultation may therefore be of interest to CRD IV firms subject to prudential supervision outside the UK.

Excess spread

The PRA's proposed changes in relation to excess spread (as detailed below) diverge from the EBA SRT DP in proposing a current requirement to, in certain circumstances, risk weight unrealised excess spread akin to a retained first loss tranche (the EBA SRT DP moots a possible future Pillar 1 capital charge for excess spread, but suggests that this is not a current CRR or Basel requirement). The proposal can be seen as conceptually at odds with the calculation mechanics for the SEC-IRBA and SEC-SA, where it is clear that unrealised excess spread does not boost the attachment and detachment points of other tranches, and with the credit enhancement level 'L' in the current SFM (though this is, in each case, also true of liquidity support, and currency and interest rate swaps provided to securitisations, which create securitisation positions for the counterparty without boosting the attachment and detachment points/credit enhancement level of other tranches). As indicated in industry responses to the EBA SRT DP, the concept of a Pillar 1 charge in respect of unrealised excess spread in a securitisation context is also at odds with the treatment of unrealised interest in the credit risk framework in general: unrealised interest not generally being treated as an asset or off balance sheet item, so that there is nothing against which to hold capital.

Presumably (as indicated in the background and rationale section of the final EBA RTS on gain on sale[12]), an originator should not be required to 1,250% risk weight/deduct a securitisation position in respect of unrealised (or indeed realised) excess spread where it has excluded a corresponding 'gain on sale' from 'future margin income' under the prudential filter in Article 32 CRR.

The CRR defines excess spread as:
"finance charge collections and other fee income received in respect of the securitised exposures net of costs and expenses."
Excess spread can be formulated in a range of different ways, and the PRA indicates that firms are required to take a "*substance over form*" approach to the treatment of excess spread features in SRT securitisations.

12_ "If the gain on sale arising from the 'future margin income' has been excluded from own funds, the corresponding asset should be excluded from the application of capital requirements."

Synthetic securitisation

The PRA indicates that a synthetic excess spread (**SES**) feature in a junior position within a synthetic securitisation capital structure impacts on the transfer of risk to third parties, by providing credit enhancement to more senior tranches. The PRA considers SES to be a complex feature, the presence of which will make it more difficult to demonstrate a commensurate transfer of risk. The PRA indicates that firms which include features such as SES in an SRT transaction should be able to demonstrate an adequate quantification of the risk retained, and reflect this retained risk in their post-transaction capital requirements. For the purposes of calculating capital requirements, the PRA proposes that SES should be treated as an off balance sheet securitisation position, the nominal value of which should be measured as a *"reasoned and prudent estimate of the credit enhancement provided by the SES feature, for example as compared to a retained first loss tranche"*. A 1,250% risk weight would apply to this nominal value, or alternatively it could be deducted from CET1 capital. No distinction is to be made between portfolios with different underlying asset classes.

We note that the PRA's proposals in relation to SES do not mirror proposals in the EBA SRT DP to require SES in SRT transactions to be: (i) a fixed annual nominal amount; and (ii) trapped.

In relation to variable SES, it is unclear whether the nominal value of the resulting securitisation position, under the PRA's proposal, would be fixed at closing, or required to be adjusted on an on-going basis to reflect excess spread expectations (eg in light of pre-payments).

Traditional securitisation

The PRA indicates that the presence of excess spread in traditional securitisations (**TES**) may, in certain transactions, impact the transfer of credit risk to third parties, where it is used to absorb losses, providing credit enhancement to more senior tranches. Where excess spread not eroded by losses can be extracted from the transaction to the benefit of the originator, as deferred consideration, eg where securitised exposures are sold at par value despite their fair value being higher than par, the PRA requires firms to treat the credit enhancement provided by TES in a similar manner to the approach described for SES, by measuring the credit enhancement provided and applying a 1,250% risk weight or deducting from capital.

The PRA's proposals in relation to TES, in the circumstances outlined above, reflect similar concerns in the EBA SRT DP, though in the EBA SRT DP the stated consequence is that the *"extent of SRT may have to be assessed with particular focus"* rather than the creation of an off balance sheet securitisation position. The EBA SRT DP also suggests that the concern only applies where a transaction fails to achieve accounting de-recognition.

Presumably it would be acceptable, under the PRA's proposals, for the purchase price for the securitised exposures to off-set the interest receivable on the securitised exposures against the discounting rate applicable to the principal amount of the securitised exposures; ie, where these rates are equal, the fair value would be par, notwithstanding the interest receivable on the securitised exposures.

Presumably only the excess of the fair value of the securitised exposures over the purchase price would need to be treated as an off balance sheet securitisation position.

It is unclear whether the nominal value of the resulting securitisation position, under the PRA's proposal, would be fixed at closing, or required to be adjusted on an on-going basis to reflect excess spread expectations (eg in light of pre-payments).

Assessing commensurate risk transfer for securitisations of SA portfolios

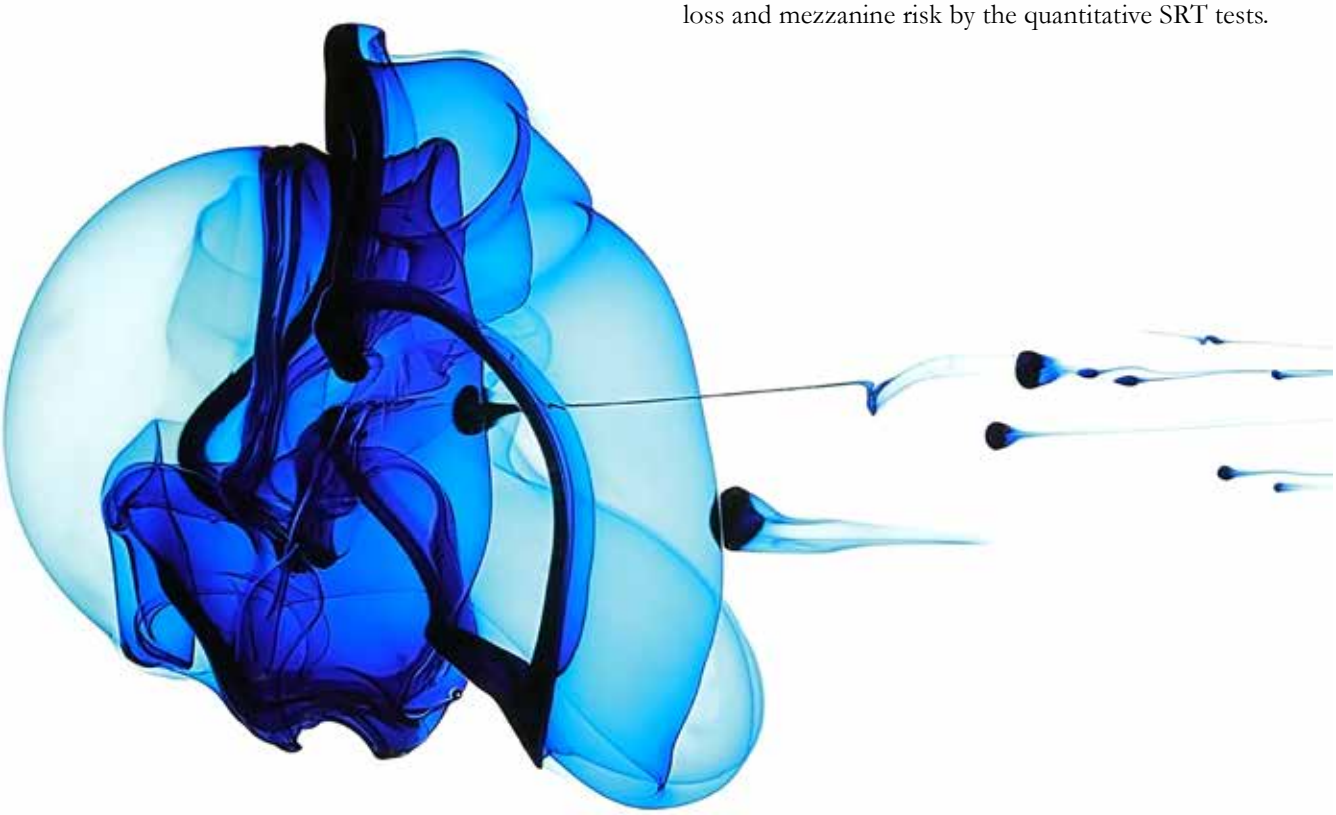
The PRA proposes to include tranche thickness as an explicit factor to be considered in achieving commensurate risk transfer (**CRT**). (By way of context, tranche thickness is already a factor that the PRA is required to consider in deciding whether to conduct a comprehensive review of an SRT transaction under the EBA SRT Guidelines, while the EBA SRT DP proposes to address a specific concern identified in relation to the current quantitative SRT tests' failure to mandate minimum thickness of the first loss tranche.)

All relevant factors must be considered in determining the thickness of tranches for SRT transactions. The PRA recognises that such analysis may be more difficult for securitisation of SA portfolios, as there may be less high-quality data available. The PRA also recognises that SA risk weights may be more or less conservative than IRB risk weights for otherwise equivalent portfolios. However, it is possible that, for some portfolios, SA risk weights may underestimate the risk on the underlying exposures, in turn overstating the risk transferred to third parties.

When justifying risk transfer for the securitisation of SA portfolios, the PRA therefore proposes that firms should consider the thickness of tranches sold, or on which protection has been purchased, in a prudent manner. To provide confidence that commensurate risk has been transferred, the PRA expects firms to compare the detachment point (D) of sold or protected tranches against the K_{SA} of the portfolio. The PRA proposes to apply a scalar of 1.5 to K_{SA} to determine the minimum value of D for these purposes, unless firms can evidence that a lower uplift factor is appropriate. The PRA is open to firms providing for a reduced scalar to K_{SA}, and will consider the use of external data sources where it is comparable and representative.

The proposal is not intended to increase capital requirements, but rather to clarify that, when justifying CRT for SRT securitisations, the protected or sold tranches should have a prudent detachment point.

It seems somewhat surprising that the scalar should not be affected by the amount of risk that an originator retains below D, but presumably the PRA is comfortable with this based on the restrictions imposed on retention of first loss and mezzanine risk by the quantitative SRT tests.



Senior management engagement in SRT securitisation

The PRA is proposing (in light of perceived divergent market practice) to align the governance expectations for SRT transactions to the Senior Managers Regime (**SMR**) so as to include individuals performing SMFs with oversight of such transactions and any employees subject to the Certification Regime involved in the transactions (eg MRTs under the Remuneration rules). Where *"complex structural features"* or *"risk characteristics that could materially affect the assessment of the risk transfer or retention"* are present (these terms are not defined in the CP, though we note that the EBA SRT DP uses the term *"complex structural features"* to refer to a number of fairly common features, such as all call options[13]), the PRA expects oversight to be linked to Prescribed Responsibility (PR) 7 (ie responsibility for managing the allocation and maintenance of the firm's capital, funding and liquidity).

The requirement for senior management involvement would apply both in relation to the initial notification of a transaction and on an on-going basis.

In balancing the need for accountability with proportionality, the level of engagement would be permitted to vary in line with the transaction's complexity or the amount of reduction in RWEAs which would be achieved by the securitisation.

The CP proposes an explicit reference to Fundamental Rule 7 (the requirement for a firm to deal with its regulators in an open and co-operative way and to disclose to the PRA anything relating to the firm of which the PRA would reasonably expect notice) in relation to SRT notifications.

13_a. amortisation structure (i.e. if not purely sequential in order of seniority), b. call options; c. excess spread, d. cost of protection for synthetic securitisations (ie high cost credit protection), e. other early termination events for synthetic securitisations, f. credit events for synthetic securitisations (see para 79 EBA SRT DP)

Timing and next steps

In keeping with the general application timing of the Securitisation Regulation and the amended CRR, the PRA proposes to apply the proposals in respect of the implementation of the Securitisation Regulation and the revised CRR securitisation capital framework from 1 January 2019. The PRA's proposals in relation to SRT are intended to take effect immediately after the publication of the relevant policy statement to all PRA-authorised CRD IV firms, however, as the proposed changes are regarded to be equally applicable to the current and amended CRR regimes.

The deadline for comments in respect of the PRA consultation paper is 22 August. We encourage interested clients to provide feedback to the consultation and to contact us with any questions.

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