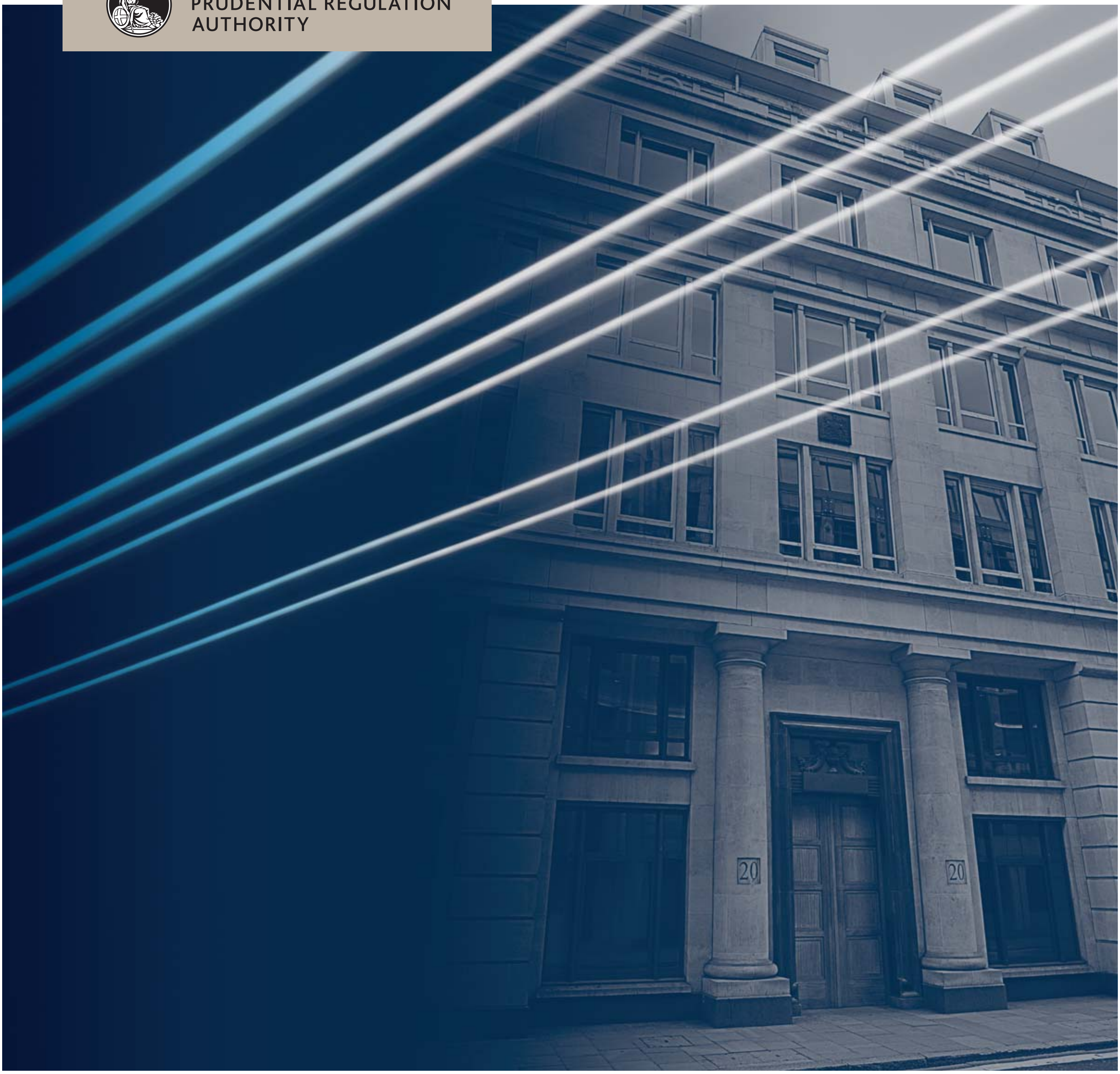
Supervisory Statement | LSS10/13

Securitisations: originators' use of the Supervisory Formula Method

April 2013

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



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From its commencement on 1 April 2013, the Prudential Regulation Authority (PRA) has adopted a number of legacy FSA policy publications relevant to the advancement of its objectives. This document, initially issued by the FSA, has been adopted by the PRA as a Supervisory Statement as part of this process. The PRA may choose to review this legacy publication at a later stage.

Introduction

This Supervisory Statement sets out expectations for firms using the Supervisory Formula Method (SFM) to calculate risk-weighted exposure amounts (RWEA) for unrated securitisation positions.

The securitisation framework has a strict hierarchy of methods to determine the capital requirements for securitisation positions (set out in BIPRU 9.12 for firms using the Internal Rating Based (IRB) approach). Where a position is rated, the firm must determine the RWEA based on the rating of the position under the Ratings Based Approach (RBA). Where a position is unrated, IRB firms may be able to use the SFM to calculate the RWEA.

The rules relating to the SFM, however, must be read against the background of the over-arching requirement for securitisation (see BIPRU 9.3.1R). Originators must transfer a significant amount of credit risk associated with the securitised exposures to third parties to be able to apply the RWEA set out in BIPRU 9. The PRA has significant concerns that firms' use of the SFM undermines the significant risk transfer (SRT) requirement with the reduction in RWEA due to the use of the SFM being disproportionate to the credit risk transferred.

Supervisory Formula Method

The SFM is a formula based on the underlying asset portfolio's capital requirement calculated under the IRB Approach. The detailed requirements are set out in BIPRU 9.12.21R to 9.12.23R. The underlying formula contains an implicit assumption that there is no systematic risk in tranches of diversified portfolios that attach at a level of credit enhancement above the capital requirement on the underlying portfolio. However, the performance of senior tranches of many securitisations since 2007 has shown this assumption to be flawed. In addition, where a firm's IRB model proves, *ex post*, to have under-estimated capital requirements on the underlying portfolio, the SFM leverages any undercapitalisation.

As a result, the SFM will very often fail to appropriately capture the risks in retained securitisation positions. Further, the regulatory capital charges generated by the SFM reduce very quickly and to an extremely low level for small increases in credit enhancement. The resulting RWEA are likely not to be justified by a commensurate transfer of credit risk to third parties, generally causing the SRT test to be failed (see BIPRU 9.3.9G).

Alternative to the use of SFM

The SFM currently gives, in many circumstances, much more favourable RWEA than the requirement that would apply if the same tranches were externally rated. To be satisfied under BIPRU 9.3.9G that commensurate risk transfer has been achieved, and therefore for firms to comply with the SRT test, the PRA will generally expect firms to obtain a public rating on retained tranches and apply the RBA instead of the SFM. For synthetic securitisations this might require firms to create an instrument relating to the retained tranche in order to obtain a rating on the tranche. Firms should be aware, however, that even the use of RBA might not be, in itself, a sufficient condition to meet the SRT test if, notwithstanding the higher RWEA that would apply to the retained position, there is not a significant transfer of risk for the overall transaction. Firms should ensure they have regard to the External Credit Assessment Institution (ECAI) provisions in BIPRU 9.7 and BIPRU 9.8 when obtaining public ratings on retained positions.

A firm may still be able to demonstrate SRT without a rating but we believe that this is likely to be exceptional and we expect firms to submit any proposal to do so to the PRA before claiming any capital relief. Two examples of 'exceptional' cases are where it is not possible to obtain a rating from an eligible ECAI, or where the small size of a transaction makes the cost of obtaining a rating disproportionate. In each case the firm must be able to provide the PRA with sufficient evidence of such 'exceptionality'. In the first example the PRA would expect this to include written confirmation that no eligible ECAIs were prepared to rate the transaction. In the second example the PRA would expect a firm to provide an analysis of the costs of obtaining a rating relative to the potential capital reduction available from the transaction. The PRA does not expect firms to seek to exploit the boundary of what might constitute 'exceptional' cases (eg by deliberately structuring many small transactions rather than a single larger transaction).

Use of SFM in the trading book

The guidance on SFM applies to firms seeking to demonstrate SRT, and BIPRU does not explicitly apply SRT to transactions originated in the trading book. In light of this, the guidance does not apply directly to the use of SFM in the trading book. However, we will closely monitor securitisation origination in the trading book for evidence of arbitrage and any undercapitalisation of retained positions. We may use our supervisory powers (normally through an add-on in Pillar 2) to correct any undercapitalisation of positions in the trading book resulting from the absence of the requirement to achieve SRT, including in circumstances where SFM has been used.

IRB firms that invest in unrated securitisation positions in either the trading book or non-trading book will not be required to obtain external ratings on such positions. However, use of SFM by investors in either the trading book or non-trading book requires PRA approval, and we will consider the nature of positions for which use of SFM is being sought, and the potential for SFM to generate inappropriate capital requirements for such positions, as part of our approval decision-making process.