

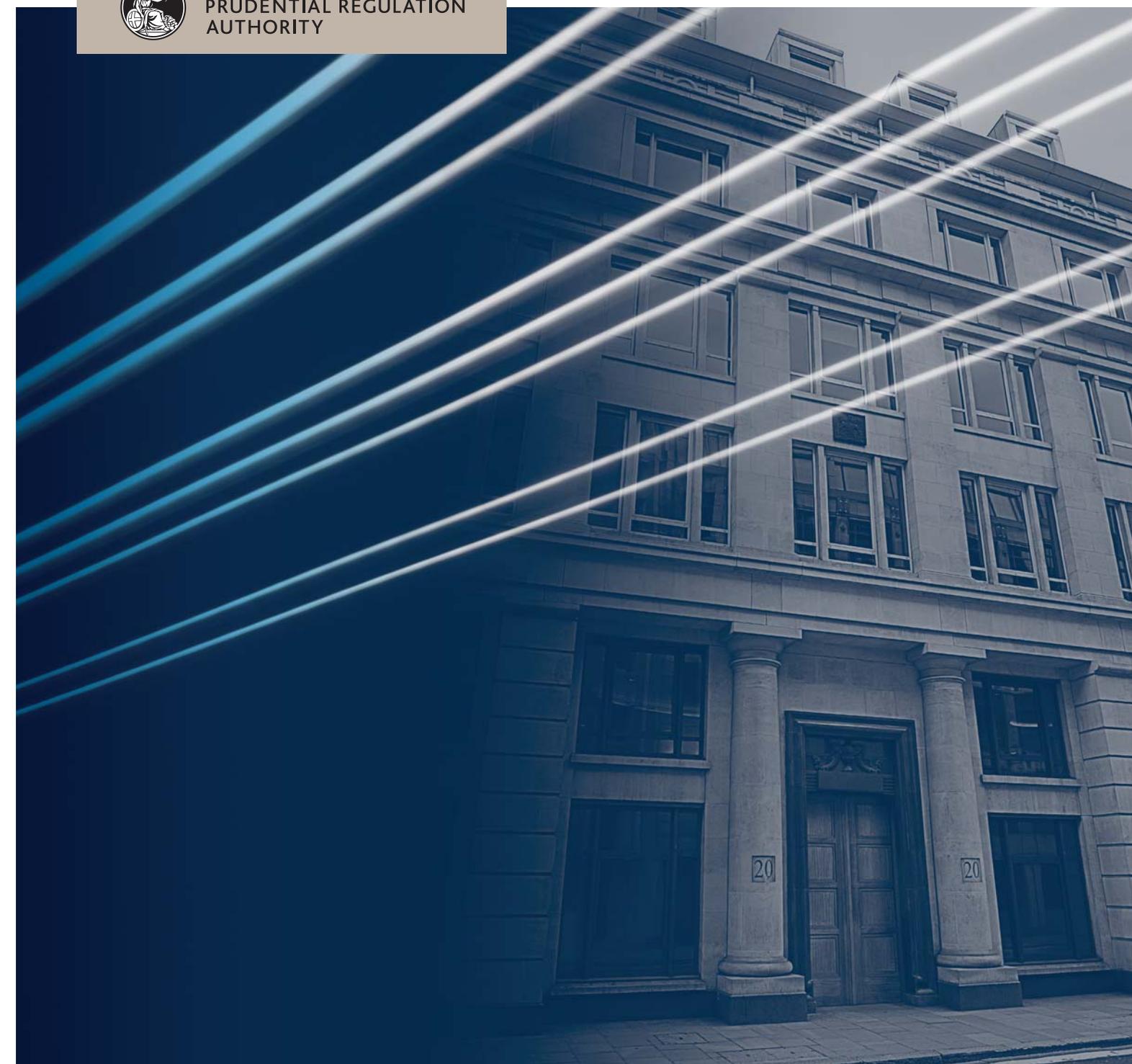
Supervisory Statement | SS9/13

Securitisation

December 2013



BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY





BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Supervisory Statement | SS9/13

Securitisation

December 2013

1 Introduction

1.1 This statement is aimed at firms to which CRD IV applies.

1.2 This statement sets out the Prudential Regulation Authority's (PRA's) expectations of firms in respect of securitisation in the following sections:

- (2) 'High-level Significant Risk Transfer considerations' — general expectations of firms seeking to obtain significant risk transfer (SRT) through securitisation;
- (3) 'Significant Risk Transfer notifications and permissions' — process for notifying the PRA of SRT transactions and for obtaining permission to undertake own assessments of SRT;
- (4) 'Regulatory capital calculation methodology and SRT' — methodologies firms use to calculate post-securitisation risk weights in SRT transactions;
- (5) 'Implicit Support and SRT' — the PRA's approach to implicit support;
- (6) 'High cost credit protection and other SRT considerations' — factors likely to affect the assessment of SRT transactions; and
- (7) 'Mapping of External Credit Assessment Institutions (ECAIs) credit assessments to credit quality steps' — the PRA's view of interim mapping of rating agency grades to credit quality steps for the purposes of securitisation positions under the Ratings Based Approach to securitisation.

1.3 The statement supplements the rules in the Benchmarking of Internal Approaches and Credit Risk Part of the PRA Rulebook.

2 High-level Significant Risk Transfer considerations

2.1 The CRR requires any reduction in capital requirements achieved through securitisation to be justified by a commensurate transfer of risk to third parties. Where the PRA determines that the reduction in risk-weighted exposure amounts (RWEA), which would be achieved through a particular securitisation transaction, is not justified by a commensurate transfer of risk then SRT shall not be considered to have been achieved by that transaction.

2.2 SRT is an ongoing requirement. Accordingly, the PRA expects firms to ensure that any reduction in capital requirements achieved through securitisation continues to be

matched by a commensurate transfer of risk throughout the life of the transaction. The PRA expects firms to take a substance over form approach to assessing SRT. Firms should be able to demonstrate that the capital relief post-transaction adequately captures the economic substance of the entire transaction, and is commensurate to the retained risks.

2.3 One indication of whether or not risk transfer is commensurate is whether the RWEA post-securitisation is commensurate with the RWEA that would apply if the firm acquired the securitised exposures from a third party. The PRA expects firms purchasing risk transfer products to give adequate consideration to all relevant factors when assessing SRT, including the size of premiums paid.

2.4 When risk transfer transactions are structured as a group of linked transactions rather than a single transaction, the PRA expects the aggregate effect of linked transactions to comply with the CRR. The PRA expects firms to ensure that analysis of risk transfer incorporates all linked transactions, particularly if certain transactions within a group of linked transactions are undertaken at off-market rates.

2.5 The PRA expects the instruments used to transfer credit risk not to contain provisions which materially limit the amount of risk transferred. For example, should losses or defaults on the securitised exposures occur — ie deterioration in the credit quality of the underlying pool — the PRA expects the originator's net cost of protection or the yield payable to investors should not increase as a result.

2.6 In order to ensure their continuing appropriateness, the PRA expects firms to update the opinions of qualified legal counsel, required by CRR, as necessary to ensure their continuing validity. For example, an opinion may need to be updated if relevant statutory provisions are amended, or where a new decision or judgment of a court has a bearing on the continuing validity of counsel's opinion.

2.7 The PRA expects relevant senior management of a firm to be appropriately engaged in the execution of securitisation transactions that lead to a reduction in RWEA, where the firm is providing or purchasing structured trades.

2.8 The PRA does not operate a pre-approval process for securitisation transactions. The PRA nevertheless expects a firm to discuss with its supervisor at an early stage securitisation transactions that are material or have complex features. Where a firm claims a regulatory capital reduction from securitisation transactions in its disclosures to the market, the PRA expects such disclosures to include caveats making clear the risk of full or partial re-characterisation where this risk is material in the light of the PRA's stated policy.

2.9 Although this supervisory statement sets out the PRA's expectations regarding securitisation, these expectations are also relevant for other similar credit protection arrangements.

2.10 The PRA will seek to ensure that the securitisation framework is not used to undermine or arbitrage other parts of the prudential framework. In relation to other similar credit protection arrangements, including those subject to credit risk mitigation or trading book rules, the impact of certain features (eg significant premiums or call options) may cast doubt on the extent of risk transferred and the resulting capital assessment.⁽¹⁾ Features which result in inadequate capital requirements compared to the risks a firm is running may result in the credit protection not being recognised or the firm being subject to extra capital charges in their Individual Capital Guidance (ICG) in the form of Pillar 2 add-ons. Credit protection arrangements in general are subject to the same overarching principles as those in the securitisation framework.

2.11 Where a firm achieves SRT for a particular transaction, the PRA expects it to continue to monitor risks related to the transaction to which it may still be exposed. The PRA expects firms to consider the capital planning implications of securitised assets returning onto their balance sheets. The CRR requires firms to conduct regular stress testing of their securitisation activities and off balance sheet exposures. The PRA expects those stress tests to consider the firm-wide impact of stressed market conditions on those activities and exposures and the implications for other sources of risk, for example, credit risk, concentration risk, counterparty risk, market risk, liquidity risk and reputational risk. The PRA expects a firm's stress testing of securitisation activities to take into account existing securitisations and pipeline transactions. The PRA expects a firm to have in place procedures to assess and respond to the results of that stress testing and would expect them to be taken into account under Pillar 2.

(CRR Articles 243, 244 and 337)

3 Significant Risk Transfer notifications and permissions

Requirements for originators to use securitisation risk weights

3.1 The CRR provides three options for firms to demonstrate how they transfer significant credit risk for any given securitisation transaction:

- (1) the originator does not retain more than 50% of the risk weighted exposure amounts of mezzanine securitisation positions, where these are:
 - (i) positions to which a risk weight lower than 1,250% applies; and

- (ii) more junior than the most senior position in the securitisation and more junior than any position in the securitisation rated Credit Quality Step 1 or 2.

- (2) where there is no mezzanine position, the originator does not hold more than 20% of the exposure values of securitisation positions that are subject to a deduction or 1,250% risk weight and where the originator can demonstrate that the exposure value of such securitisation positions exceeds a reasoned estimate of the expected loss on the securitised exposures by a substantial margin; and
- (3) the competent authority may grant permission to an originator to make its own assessment if it is satisfied that the originator can meet certain requirements.

SRT under options (1) and (2)

3.2 Credit Risk 3.1 in the PRA Rulebook requires a firm to notify the PRA of each transaction on which it seeks capital relief under options 1 and 2.

3.3 Where the PRA considers that the possible reduction in RWEA achieved via the securitisation is not justified by a commensurate transfer of risk to third parties, then the PRA will find SRT has not been achieved. Consequently, firms will not be able to recognise any reduction in RWEA from the transaction.

(CRR Articles 243, 244 and 337)

SRT option 3

3.4 The PRA intends to grant permission for an originator to make its own assessment of SRT only where it is satisfied that:

- in every relevant case, the reduction in capital requirements achieved would be justified by a commensurate transfer of risk to third parties;
- the firm has in place appropriately risk-sensitive policies and methodologies to assess the transfer of risk; and
- such transfer of risk to third parties is also recognised for the purposes of the firm's internal risk management and internal capital allocation.

3.5 Where the PRA grants permission for multiple transactions, that permission will cover a defined scope of potential transactions. The permission will enable a firm (within certain limits) to carry out these transactions without notifying the PRA in each individual instance.

(1) Article 194(2) of the CRR requires firms to, 'take all appropriate steps to ensure the effectiveness of the credit protection arrangement and to address the risks related to that arrangement'.

(CRR Articles 243, 244 and 337)

Deduction or 1,250% risk weighting

3.6 A firm seeking to achieve capital relief by deducting or applying a 1,250% risk weight to all retained positions where permitted under CRR Article 243 or 244 would not need to make a notification under Credit Risk 3. In such cases, a firm should consider whether the characteristics of the transaction are such that the PRA would reasonably expect prior notice of it.

(CRR Articles 243, 244)

SRT notifications

Process for submitting notifications

3.7 When informing the PRA of a transaction in accordance with Credit Risk 3.1, the information should be sent simultaneously via email to the SRT notifications inbox (SRT@bankofengland.co.uk) and to the firm's usual supervisory contact.

Information to be provided

3.8 A firm's notification should include sufficient information to enable the PRA to assess whether the possible reduction in RWEA which would be achieved by the securitisation is justified by a commensurate transfer of credit risk to third parties. The PRA expects such information to include at least the following:

- (a) details of the securitisation positions, including rating, exposure value and RWEA broken down by securitisation positions sold and retained;
- (b) a copy of the SRT policy applied to the transaction, including details of the methodology and any models used to assess risk transfer;
- (c) a statement of how all relevant risks are incorporated into the SRT assessment and how the full economic substance of the transaction is taken into consideration;
- (d) the SRT calculation, setting out why the firm believes the capital relief proposed is commensurate with the credit risk transferred to third parties;
- (e) details of reliance on external credit assessment institutions (ECAIs) in the SRT assessment;
- (f) a description of the risks being retained;
- (g) key transaction documentation and any relevant supporting documents (eg a summary of the transaction);
- (h) copies of investor and internal presentations on the transaction;

- (i) details of the underlying assets (including asset class, geography, tenor, rating, spread, collateral, exposure size);
- (j) details of the transaction structure;
- (k) details of any termination options (eg call options);
- (l) details of the cash flow between parties involved in the transaction;
- (m) details of the ratings and pricing of bonds issued in the transaction;
- (n) details of any connected parties involved in the transaction;
- (o) details of the rationale for the transaction;
- (p) details of the CRR rules the firm is relying on; and
- (q) details of the governance process for the transaction, including details of any committees involved in approving the transaction.

Communicating PRA decisions on notified transactions

3.9 Following review of sufficient information provided by the firm, the PRA will inform the firm of its view on commensurate risk transfer. The PRA's review will focus on the proportion of credit risk transferred — including any transaction features which undermine effective risk transfer — compared to the proportion by which RWEA is reduced as a result of the transaction. Where the PRA judges the reduction in RWEA not to be justified by a commensurate transfer of credit risk to third parties, it will inform the firm that SRT has not been achieved by this transaction. Otherwise the PRA will inform the firm that it does not object to the transaction.

3.10 The PRA does not intend to pre-approve transactions. Instead, the PRA will provide a view on whether it considers commensurate risk transfer to have been achieved at a point in time, which may be provided after a transaction has closed. The PRA may reassess its judgement of the achievement of commensurate risk transfer if the level of credit risk transfer in a transaction changes materially.

Permissions for own assessment of SRT

3.11 Firms may apply for permission to consider SRT to have been achieved without needing to rely on option (1) or (2). The scope of such permission may be defined to cover a number of transactions or an individual transaction.

(CRR Articles 243 and, 244 and 337)

Multiple transaction permissions

3.12 Where a firm applies for such permission, the PRA expects the scope to be defined according to a range of characteristics, including the type of asset class and the structural features of the transaction. The characteristics that the PRA expects a firm to consider when defining the scope of a permission application include:

- (a) asset class (eg residential or commercial mortgages, credit card receivables, leasing, loans to corporates or small and medium-sized enterprises, consumer loans, trade receivables, securitisations, Private Finance Initiative, insurance, covered bonds, other assets);
- (b) further asset class distinction (eg geography and asset quality); and
- (c) structural features (eg distinguishing between securitisation and re-securitisation, traditional and synthetic securitisation and non-revolving structures and revolving structures).

3.13 It is likely to be more straightforward for the PRA to assess applications for relatively narrowly scoped permissions than those covering a wide range of assets and/or with complex structural features.

PRA areas of review and information to be submitted by firms

3.14 In order to assess a firm's ability to use its own policies and methodologies for assessing SRT, the PRA's permission application reviews will focus on the following factors:

- the firm's understanding of the risk of potential transactions within the scope of the permission, including for potential underlying assets, securitisation structures and other relevant factors that affect the economic substance of risk transfer;
- the firm's governance around SRT assessment (including sign-off procedures) and systems and controls relating to risk-transfer assessment and determination of SRT;
- SRT calculation policies and methodologies, including models used;
- the firm's historical experience with relevant securitisation origination; and
- the use of third-party risk assessments (eg external ECAI ratings) and the relationship with internal assessments.

3.15 The information the PRA expects a firm to provide in a permission application includes the following:

- (a) details of the firm's governance processes for SRT, including details of any relevant committees and the seniority and expertise of key persons involved in sign-off;
- (b) a copy of the firm's SRT policy, including details of the SRT calculation policies, methodologies and any models used to assess risk transfer (this should set out how the firm ensures it only takes capital relief in proportion to the amount of risk transferred on any given transaction);
- (c) a statement of how all relevant risks are incorporated in the SRT calculations and how the full economic substance of transactions is taken into consideration;
- (d) details of the firm's systems and controls regarding risk transfer in securitisations;
- (e) a copy of the firm's capital allocation strategy;
- (f) details of any securitised assets that have come back on the firm's balance sheet and the reason why; and
- (g) details of reliance on ECAs in determining SRT.

Limits attached to multiple transaction permissions

Materiality

3.16 The PRA will apply two materiality limits to the proportion of RWEA reduction that can be taken under any permission covering multiple transactions:

- (a) transaction level limit — any transaction that would in principle be within the scope of the permission, but that resulted in an RWEA reduction exceeding 1% of the firm's credit risk related RWEAs, as at the date of the firm's most recent regulatory return, will fall outside the scope of a multiple transaction permission and will require a separate permission or require notification (if the transaction would satisfy option 1 or 2); and
- (b) aggregate limit — once the aggregate RWEA reduction on all SRT transactions executed within the scope of a permission exceeds 5% of the firm's credit risk-related RWEAs as at the date of the firm's most recent regulatory return, no additional transactions may be executed within scope of the permission. In such circumstances, a firm should take one of the following actions:
 - (i) apply to renew the multiple transaction permission;
 - (ii) apply for a new permission covering the specific transactions exceeding the RWEA limit; or

- (iii) notify the PRA of the transaction, following the SRT notification procedure (if the transactions would satisfy option 1 or 2).

Length of permission

3.17 Multiple transaction permissions will be granted for a period of one year. The PRA's review of permission renewal will focus on changes to the firm's SRT policies and methodologies since the previous review.

Individual transaction permissions

3.18 Permissions relating to individual transactions need not be granted prior to the execution of a transaction. The PRA does not intend to specify the timeframe in which a firm should submit an individual transaction permission application, but firms should note that capital relief from a specific transaction will not be available until a firm has obtained permission covering the SRT assessment and capital treatment (unless the transaction is being notified under option 1 or 2, or falls within scope of a multiple transaction permission).

3.19 The information the PRA expects to receive in an individual transaction permission includes the items set out in paragraph 3.8 points d to p, and paragraph 3.15 points a to c.

Limits attached to individual transaction permissions

3.20 The PRA may grant an individual permission for the full duration of a transaction, or may impose a shorter time limit on the permission. Where a firm seeks to take capital relief on a transaction beyond the expiry date of the relevant permission, the permission will require renewal prior to expiry.

3.21 As SRT should be met on a continuing basis, permissions will typically include a requirement to notify the PRA of changes in circumstances from those under which the permission was granted. Any reduction in credit risk transfer subsequent to the permission being granted will require the firm to make a commensurate reduction in the extent of RWEA reduction that is recognised. If a firm does not effect a commensurate reduction in the RWEA relief in such circumstances, the PRA may revoke the relevant permission.

(CRR Articles 243, 244 and 337)

4 Regulatory capital calculation methodology and SRT

4.1 Originators must transfer a significant amount of credit risk associated with securitised exposures to third parties to be able to apply the securitisation risk weights set out in Chapter 5 of the CRR, and any associated reduction in capital requirements must be matched by a commensurate transfer of risk to third parties.

4.2 As part of the notification and permissions process, the PRA expects a firm to inform it of the methodology the firm intends to use to calculate securitisation capital requirements. The PRA will generally be more sceptical of the achievement of commensurate risk transfer for transactions where the regulatory capital calculation used produces very low capital requirements. Where the method used to calculate regulatory capital requirements post-securitisation results in a particularly significant reduction in capital requirements, the PRA will apply a high degree of scrutiny in its assessment of whether commensurate risk transfer is achieved.

(CRR Articles 243, 244 and 337)

5 Implicit support and SRT

5.1 The PRA will monitor the support provided by a firm to its securitisation transactions, and will consider this carefully in the assessment of commensurate risk transfer. As part of firms' ongoing consideration of risk transfer, the PRA expects them to consider the support they have provided to securitisation transactions.

5.2 If a firm is found to have provided support to a securitisation, the expectation that the firm will provide future support to its securitisations is increased. The PRA will take account of this increased expectation in future assessments of commensurate risk transfer for that firm.

5.3 The PRA expects securitisation documentation to make clear, where applicable, that repurchase of securitisation positions by the originator beyond its contractual obligations is not mandatory and may only be made at fair market value.

5.4 Where a firm provides support which it is entitled, but not obliged, to provide under the contractual documentation of the securitisation, the PRA will consider the following factors in assessing if that support has been appropriately reflected in the assessment of SRT:

- (a) whether the fact that the firm may provide such support was expressly set out in the contractual and marketing documents for the securitisation;
- (b) whether the nature of the support that the firm may give is precisely described in the documentation;
- (c) whether the maximum degree of support that could be provided could be ascertained at the time of the securitisation by the firm and by a person whose only information came from the marketing documents for the securitisation;
- (d) whether the assessment of whether SRT was achieved and the amount of that risk transferred was made on the basis

that the firm would provide support to the maximum degree possible; and

- (e) whether the firm's own funds and own funds requirements were appropriately adjusted at the time of the securitisation on the basis that the firm provided support to the maximum degree possible.

5.5 If a firm fails to comply with CRR Article 248(1), the PRA may require it to disclose publicly that it has provided non-contractual support to its transaction.

(CRR Articles 243, 244, 248 and 337 and CRD4 Article 98)

6 High-cost credit protection and other SRT considerations

6.1 Some transactions transfer little or no economic risk from the protection buyer to the protection seller, but may nevertheless result in a reduction in regulatory capital requirements. An example of such a transaction-type is one in which protection is purchased on a junior tranche and a high premium is paid for that protection.

6.2 Generally, the amount of premium paid will not materially affect the assessment of whether SRT is achieved. This is because either:

- the protection payment payable upon default from protection seller to protection buyer is significantly larger than the overall premium payable to the protection seller; or
- the payment of premium leads to an immediate incurred cost.

6.3 However, there comes a point at which the premium payable for protection can reduce significantly the economic risk that is transferred from the protection buyer to protection seller. A premium payable of 100% of the protection amount could leave the protection buyer in a position over the life of the transaction that was no better than if protection had not been purchased.

6.4 The PRA expects originators seeking to apply the securitisation risk weights to synthetic securitisations to take into account all relevant factors to assess the extent of risk transferred. As well as the size and timing of amounts payable to the protection seller, the circumstances in which those amounts are payable can undermine the effectiveness of risk transfer. The PRA expects firms seeking capital relief through synthetic securitisations to incorporate premiums in their assessment of SRT. In particular, the following transaction features may have a significant impact on the extent of risk transfer:

- premium which is guaranteed in all or almost all circumstances, eg premium which is payable upfront or deferred;
- those that could result in the amount of premium payable for protection being significantly greater than the spread income on the assets in the portfolio or similar to the size of the hedged position; and
- those under which the protection buyer retains the expected loss through higher transaction costs to the counterparty, in the form of premium or otherwise.

6.5 Originators should have regard to the statement on high cost credit protection issued by the Basel Committee on Banking Supervision (www.bis.org/publ/bcbs_n16.htm).

6.6 The CRR requires maturity to be assessed in considering SRT. When assessing the effective maturity of synthetic securitisations, the PRA expects firms to consider whether the transaction contains an option to terminate the protection at the discretion of the protection buyer. The PRA will consider the following to be examples of features which generally indicate a positive incentive for the protection buyer to call a transaction, or at least to constitute grounds for discussion with the PRA prior to the conclusion of the transaction:

- the transaction contains terms, such as payments at maturity or payments upon early termination or significant premiums, which may reduce risk transfer;
- the transaction includes a requirement for the protection buyer to incur additional costs or obligations if they do not exercise their option to terminate the protection; and
- there are pre-agreed mechanisms, for example 'at-market unwinds', where the protection seller and protection buyer agree that the transaction can be terminated in the future at a 'market' value and specifies aspects of how the value is calculated.

(CRR Articles 243, 244 and 337)

7 Mapping of ECAI credit assessments to credit quality steps

7.1 The CRR requires the European Banking Authority (EBA) to produce implementing technical standards (ITS) mapping the credit assessments of ECAs to the credit quality steps specified in the CRR for the purposes of calculating risk-weighted exposure amounts under the ratings-based approach.

7.2 EBA is required to submit those draft ITS to the European Commission by 1 July 2014. Prior to adoption of the EBA's ITS,

the PRA would expect firms to continue to use the PRA mapping of ECAI credit assessments to credit quality steps, as set out in Tables 1–4 below. These tables will be superseded by the EBA’s mapping once that mapping has been adopted by the Commission.

Table 1 Long-term mapping: standardised approach

Credit quality step	Risk weights	Fitch	Moody's	S&P	DBRS
1	20%	AAA to AA-	Aaa to Aa3	AAA to AA-	AAA to AAL
2	50%	A+ to A-	A1 to A3	A+ to A-	AH to AL
3	100%	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-	BBBH to BBBL
4	350%	BB+ to BB-	Ba1 to Ba3	BB+ to BB-	BBH to BBL
5	1,250%	B+ and below	B1 and below	B+ and below	BH and below

Table 2 Long-term mapping: IRB approach

Credit quality step	Risk weights			Credit assessments			
	Most senior tranche	Base	Non-granular pool	Fitch	Moody's	S&P	DBRS
1	7%	12%	20%	AAA	Aaa	AAA	AAA
2	8%	15%	25%	AA	Aa	AA	AA1
3	10%	18%	35%	A+	A1	A+	AH
4	12%	20%	35%	A	A2	A	A
5	20%	35%	35%	A-	A3	A-	AL
6	35%	50%	50%	BBB+	Baa1	BBB+	BBBH
7	60%	75%	75%	BBB	Baa2	BBB	BBB
8	100%	100%	100%	BBB-	Baa3	BBB-	BBBL
9	250%	250%	250%	BB+	Ba1	BB+	BBH
10	425%	425%	425%	BB	Ba2	BB	BB
11	650%	650%	650%	BB-	Ba3	BB-	BBL
Below 11	1,250%	1,250%	1,250%	Below BB-	Below Ba3	Below BB-	Below BBL

Table 3 Short-term mapping: standardised approach

Credit quality step	Risk weights	Fitch	Moody's	S&P	DBRS
1	20%	F1+, F1	P-1	A-1+, A-1	R-1 (high), R-1 (middle), R-1 (low)
2	50%	F2	P-2	A-2	R-2 (high), R-2 (middle), R-2 (low)
3	100%	F3	P-3	A-3	R-3
All other credit assessments	1,250%	Below F3	NP	All short-term ratings below A3	All short-term ratings below R-3

Table 4 Short-term mapping: IRB approach

Credit quality step	Risk weights			Credit assessments			
	Most senior tranche	Base	Non-granular pool	Fitch	Moody's	S&P	DBRS
1	7%	12%	20%	F1+, F1	P-1	A-1+, A-1	R-1 (high), R-1 (middle), R-1 (low)
2	12%	20%	35%	F2	P-2	A-2	R-2 (high), R-2 (middle), R-2 (low)
3	60%	75%	75%	F3	P-3	A-3	R-3
All other credit assessments	1,250%	1,250%	1,250%	Below F3	All short-term ratings below A3, P3 and F3	All short-term ratings below A3	All short-term ratings below R-3