Briefing
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Securitisation and capital requirements

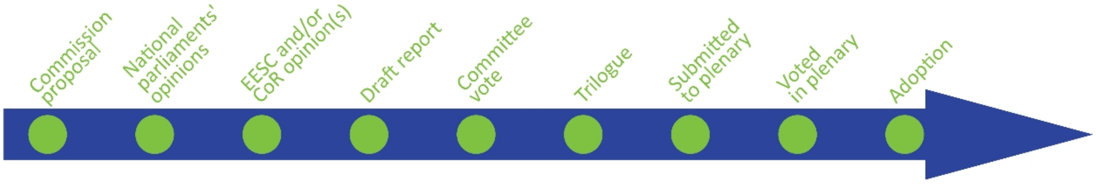
SUMMARY

As part of its ambition to create a Capital Markets Union, the European Commission wants to revive the securitisation market in the EU, in order to offer new financing tools and ease credit provision, especially for small and medium-sized enterprises. Its 'securitisation initiative', set out in a proposed regulation on 30 September 2015, would establish a new framework for 'simple, transparent, and standardised' (STS) securitisations. This new initiative also has implications for the overall prudential framework for credit institutions and investment firms, therefore the Commission proposed to amend the Capital Requirements Regulation (EU) No 575/2013 accordingly. The proposed amendments would adjust risk retention profiles to reflect properly the specific features of STS securitisations. The most significant changes are: a new hierarchy of risk calculation methods and lower capital requirements for STS. The Council agreed on a general approach on both dossiers in early December 2015. Parliament's ECON Committee adopted its report a year later, and the two institutions reached agreement on the text in trilogue in June 2017.

This briefing further updates an earlier edition of July 2016: [PE 573.935](). See also our updated briefing on the related proposal: [PE 608.777]().

Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 575/2013 on prudential requirements for credit institutions and investment firms

Committee responsible:	Economic and Monetary Affairs (ECON)	COM(2015) 473 *of* 30.9.2015
Rapporteur:	Othmar Karas (EPP, Austria)	*procedure ref.*: 2015/0225(COD)
Procedure completed.	Regulation (EU) 2017/2401 [OJ L 347, 28.12.2017, p. 1.]()	Ordinary legislative procedure



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PE 608.778

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Introduction

In the context of its efforts to build a Capital Markets Union (CMU), the European Commission proposed on 30 September 2015, in addition to an action plan regarding upcoming legislation, a **'securitisation initiative'**. This initiative consists of two pieces of legislation: a first regulation setting out common rules on securitisation and providing a framework for simple, transparent and standardised (STS) securitisations. And a second regulation amending the existing Capital Requirements Regulation (CRR – 575/2013), to accommodate the proposed common rules and the new STS framework in the overall prudential framework. Initiated by the Commission on the basis of Article 114 (1) TFEU, the ordinary legislative procedure applies. The proposed STS framework should **improve the evaluation of risks for investors**. The accompanying regulation to amend the regulatory capital treatment for credit institutions originating, sponsoring or investing in them **establishes preferential treatment** for certain securitisation transactions, in order to ease credit provision and 'unlock additional sources for long-term finance', especially to SMEs.

Context

Labelled as the 'CRD IV package', international standards on bank capital adequacy (known as Basel I, II, & III[1] provisions) were transposed into EU law through two central pieces of legislation, the 'Capital Requirements Directive', CRD (2013/36/EU) and the 'Capital Requirements Regulation', CRR (575/2013). The latest revision, known as CRD IV, has been in force since 1 January 2014. While CRD IV governs access to deposit-taking activities, the CRR establishes the prudential requirements that institutions need to respect. Developments at global level lead to the need to adjust EU legislation. With regard to securitisations, the BCBS issued a revised securitisation framework (coming into effect in January 2018) on 11 December 2014, and an accompanying consultative document on 10 November 2015. Insofar as the Commission's securitisation proposal implies necessary amendments to the CRR, the proposed regulation incorporates the revised BCBS framework.[2]

Existing situation

With regard to **banking**, the CRR (Regulation (EU) 2013/575), lays down uniform rules for credit institutions and investment firms concerning general prudential requirements regarding own funds relating to − among others − elements of credit risk, market risk, operational risk and settlement risk. This current 'CRR Regulation' became effective as of 1 January 2014, replacing the Capital Requirements Directives (2006/48/EC and 2006/49/EC). The Regulation is supplemented by two Commission Delegated Acts, four Commission Implementing Acts, regulatory technical standards (RTS), and implementing technical standards (ITS).[3]

The changes the proposal would bring

The specific amendments to the proposal to recalibrate the CRR requirements entail:

Linkages between the new securitisation regulation and CRR

Capital requirements for positions in securitisation, including the more risk-sensitive treatment for STS securitisations, are set out in the CRR proposal, while STS eligibility criteria and other cross-sectoral provisions on risk retention, due diligence and disclosure requirements, previously listed in Part V of CRR, were moved to the securitisation proposal. According to the Commission, the equally necessary adaptation of the 'LCR Regulation' Delegated Act will take place at a later stage.[4]

Calculating minimum capital needs for securitisation positions

In order to preserve and enhance the internal consistency and overall coherence of the text, Chapter 5 of Title II, Part Three of CRR is replaced by the current proposal. The new Articles 254 to 270a, in line with the revised BCBS framework, implement a new hierarchy of applicable approaches for the calculation of risk-weighted assets, i.e. to know the minimum capital needs for securitisation exposures. The decision on the approach to choose depends on the information available to the credit institution or investment firm holding the securitisation position.[5]

A new hierarchy of approaches

The Commission follows closely the BCBS framework and sets the 'Securitisation Internal Ratings-Based Approach **(SEC-IRBA)**' at the top of the revised hierarchy of credit risk calculation approaches (SEC-IRBA → SEC-ERBA → SEC-SA, see below) with K_{IRB} information as a key input. K_{IRB} is the capital charge for the underlying exposures using the IRB framework. Such an internal ratings-based approach, developed as part of the Basel II framework in 2004, allows banks to use 'their own internal measures for key drivers of credit risk as primary inputs to the capital calculation, subject to meeting certain conditions and to explicit supervisory approval'. In order to use the SEC-IRBA, the bank shall have: (i) a supervisory-approved IRB model for the type of underlying exposures in the securitisation pool; and (ii) sufficient information to estimate K_{IRB}. Since the relevant effects of maturity are not fully captured through K_{IRB} alone, the SEC-IRBA explicitly incorporates **tranche maturity as an additional risk driver**.[6]

An institution that cannot calculate K_{IRB} for a given securitisation position will have to use the External Ratings-Based Approach **(SEC-ERBA)** for the calculation of the risk-weighted exposure amounts. Under the ERBA, risk-weights are assigned according to credit assessments (or inferred ratings), the seniority of the position and the granularity of the underlying pool. Where an institution cannot use the SEC-ERBA, it shall apply instead the Securitisation Standardised Approach **(SEC-SA)**.[7]

Where the SEC-ERBA results in regulatory capital requirements which are not commensurate to the credit risk embedded in the exposures underlying a securitisation, institutions may apply the SEC-SA directly in relation to the positions of that securitisation, subject to the competent authority's review. An institution that cannot use SEC-IRBA, SEC-ERBA, or SEC-SA for a given securitisation exposure will have to assign the exposure a risk weight of 1250%. A **risk weight floor of 15%** is set for all securitisation exposures and for all three approaches. This is necessary to cope with certain risks, including model and agency risks, which are arguably more acute for securitisation exposures than for other categories of exposure, and can lead to a certain amount of uncertainty in capital estimates.

Preferential treatment of STS securitisations

A **more risk-sensitive** prudential treatment is provided for STS securitisations, in line with the methodology proposed by the EBA in the report on qualifying securitisations, under all the three new approaches for the calculation of risk-weighted assets (new Articles 260, 262, and 264). The three approaches are re-calibrated for all tranches in order to **generate lower capital charges** for positions in transactions qualifying as STS securitisations. In addition to the re-calibration, senior positions in STS securitisations will benefit from a **lower floor of 10%** (instead of 15%, which will remain applicable to both non-senior positions in STS securitisations and to non-STS securitisations more generally). Over time, senior tranches in securitisations that met many of the STS criteria, have performed materially better than non-senior qualifying tranches. According to the EBA, this is due to the fact that STS features are able to materially reduce model and agency risks. For the purposes of calculating risk-weighted exposure amounts, eligible STS securitisations must fulfil additional requirements: credit-granting standards, minimum granularity and maximum risk weights under the SA approach.

Senior positions in SME securitisations (new Article 270)
Article 270 targets in particular those securitisations of SME loans where the credit risk related to the mezzanine tranche (and in some cases the junior tranche) is guaranteed by a restricted list of third parties, including in particular the central government or central bank of a Member State, or counter-guaranteed by one of these (this scheme is usually defined as 'tranched cover'). Given the relevance of these schemes in order to free capital to be used to increase lending to SMEs, it is proposed to **grant a more risk-sensitive treatment**, equivalent to that foreseen for STS securitisations, to the senior tranche retained by the originator institution.[8]

Caps
The maximum risk weight for senior securitisation positions (new Article 267)
Under the 'look-through' approach, a securitisation position receives a maximum risk weight equal to the average risk weight applicable to the underlying exposures. According to existing rules, the look-through approach can be used for the calculation of risk-weighted exposure of unrated positions (Article 253 CRR). It is now proposed, in line with the revised BCBS framework, to **allow the look-through approach only for senior securitisation positions**, whether or not the relevant position is rated, and regardless of the approach used for the underlying pool of exposures (SA or IRBA), provided that the bank is able to determine KIRB or KSA for underlying exposures. In light of the credit enhancement the senior tranches receive from subordinated tranches, an institution should not have to apply to a senior securitisation position a higher risk weight than that it held directly in relation to the underlying exposures.

Maximum capital requirements (new Article 268)
An **overall cap in terms of maximum risk-weighted exposure amounts** is currently planned for institutions that can calculate KIRB (Article 260). It is now proposed to a) keep this treatment, i.e. institutions that use the SEC-IRBA for a securitisation position may apply a maximum capital requirement for that position equal to the capital requirement that would have been held against the underlying exposures under the IRB had they not been securitised; and b) **extend the same treatment to originator and sponsor institutions using SEC-ERBA and SEC-SA.** This can be justified on the grounds that, from an originator's standpoint, the securitisation process can be viewed as similar to credit risk mitigation, i.e. it has the effect of **transferring at least some of the risks** of the underlying exposures to another party. From this perspective, provided the conditions for significant risk transfer are fulfilled, it would be not justified for an institution to have to hold more capital after securitisation than before, as the risks attached to the underlying exposures are reduced through the process of securitisation.

Elimination of special treatment for certain exposures
In order to further reduce complexity and improve consistency within the securitisation framework, a series of special treatments currently provided for in the CRR are to be eliminated: (i) Second-loss or better positions in ABCP programmes (current Article 254); (ii) Treatment of unrated liquidity facilities (current Article 255); (iii) Additional own funds

securitisations of revolving exposures with early amortisation provisions (current Article 256).

Treatment of specific exposures

Re-securitisations (new Article 269)

A more conservative version of the SEC-SA will be the only approach available for re-securitisation positions, which will be subject to a significantly higher risk-weight floor (100%).

Senior positions in SME securitisations (new Article 270)

Article 270 targets in particular those securitisations of SME loans where the credit risk related to the mezzanine tranche (and in some cases the junior tranche) is guaranteed by a restricted list of third parties, including in particular the central government or central bank of a Member State, or counter-guaranteed by one of these (this scheme is usually defined as 'tranched cover'). Given the relevance of these schemes in order to free capital to be used to increase lending to SMEs, it is proposed to grant a more risk-sensitive treatment, equivalent to that foreseen for STS securitisations, to the senior tranche retained by the originator institution.[9]

Remaining changes

Amending Article 456, the Commission aims to have the possibility to adopt delegated acts in order to incorporate any relevant developments at international level (e.g. hierarchy of approaches) with particular regard to the BCBS. Impact evaluation will start three years from the date of entry into force of the regulation (review clause (Article 519a)).

Legislative process

The **Council's** working party on financial services examined both the proposals on common securitisation rules and the STS framework,[10] and on prudential requirement amendments. It agreed on an amended text in November 2015, with ministers in the Council agreeing on its general approach on 7 December, thus setting out their position for negotiations with Parliament.

The proposed amendments aim, inter alia: (i) to enhance the definitions of Article 242 point 6 so that even two or more securitisation positions (with different maturities) could qualify as senior positions, to delete point 8 on the 'standardised approach (SA) pool', and to explicitly include promotional banks (new point 23); (ii) to alter Article 248 on exposure value; (iii) to modify Article 254 on the hierarchy of calculation methods, as well as (iv) Article 255 on determining capital charges, such as K_{IRB}. While the first Presidency compromise proposed to relax 2b provisions in both Article 244 on traditional securitisations and Article 245 on synthetic securitisations with regard to mezzanine positions, the modified text of 24 November withdrew this suggestion again. The final compromise text of 30 November, as endorsed in the December ECOFIN meeting, contained only marginal changes compared to the previous Presidency compromise, including a precision on when to derogate from SEC-ERBA and use SEC-SA instead (Article 254, new 3a, b, c).

On 19 December 2016, the **European Parliament's** Economic and Monetary Affairs Committee adopted its report (40 votes for and 9 against). The main amendments introduced by the ECON committee report are the following:

The amendment to Article 254 disallows SEC-ERBA for STS securitisations and STS-ABCPs (Asset Backed Commercial Papers). According to the amendment, the revised hierarchy of methods becomes SEC-IRBA (Internal Ratings Based approach) and, if this cannot be used, SEC-SA (Standardised Approach to credit risk).

The amendment to article 270 eases the requirement that 'a securitisation is backed by a pool of exposures to undertakings, provided that at least 80 % of those in terms of portfolio balance qualify as SMEs' to at least 70 %**.**

A (new) article 270f entrusts the European Systemic Risk Board with the macroprudential oversight of the European Union's securitisation market, and the EBA with microprudential oversight. The article further empowers the Commission to adjust (after the publication of the biennial report on the securitisation market) the risk floor levels for securitisations (see articles 259-264), the leverage ratio, liquidity coverage ratio and net stable funding ratio for credit institutions and investment firms active in the securitisation market and; the use by national competent authorities of the lender-based macroprudential tools assigned to them under articles 124 and 126 to increase the risk weights on real estate loans or to increase the loss given default on securitised residential loans.

The aforementioned biannual report is described in article 519a, the amendment of which broadens the scope of elements to be considered, to the potential creation of speculative bubbles on the property market and the increased interconnection between financial institutions; the measures necessary to reduce and counter any negative effects of securitisations on financial stability (including the possible introduction of a maximum limit on exposure in securitisation as a share of total assets); and to the effects on the stability of lending transactions and the ability to provide a sustainable funding channel to the real economy, with particular attention to SMEs.

On 30 May 2017, a provisional agreement was reached in trilogue with the Council. According to the main points of the agreement:

The reference to an external credit assessment institution is deleted from Article 134(6) of Regulation (EU) No 575/2013.

Points 8 on the 'standardised approach (SA) pool' and 10 on 'credit enhancement' are deleted from the definitions of Article 242 and (new) points 17-20 ('mezzanine securitisation position', 'securitisation position', 'asset-backed commercial paper transaction' and 'promotional entity') are added.

Article 248(1b) is modified so that cash advance facilities are included and so that there is the possibility for the originator to deduct from the exposure value of specific securitisation positions the amount of the specific credit adjustments on the underlying exposures, as well as any non-refundable purchase price discounts connected with such underlying exposures.

Article 254 on the hierarchy of calculation methods is modified. The revised hierarchy is SEC-IRBA → SEC-SA and, only if SEC-SA cannot be used, then SEC-ERBA. Further, in specific cases, for rated positions, or positions in respect of which an inferred rating may be used, institutions must use SEC-ERBA instead of SEC-SA. Lastly, in cases not covered by the previous provision (and by way of derogation from paragraph 1(b)), institutions may apply SEC-ERBA instead of SEC-SA to all their rated securitisation positions.

Article 256 on attachment and detachment points is modified to include the case where two or more senior positions of the same transaction have different maturities but share pro rata loss allocation (article 256(5)).

Regarding the calculation of risk-weighted exposure amounts under SEC-ERBA, a new point states that an institution holding a securitisation position in the form of a derivative to hedge market risks may attribute to that derivative an inferred risk weight equivalent to the risk weight of the reference position[11] calculated in accordance with that Article (Article 261).

According to (new) Article 519a, 3 years after the entry into force of the regulation, the Commission must report to the Parliament and Council with regard to the impact of the hierarchy of methods (Article 254) and of the calculation of the risk-weighted exposure amounts of securitisation positions (Article 258-266) on issuance and investment activity; the effects on the financial stability of the EU, focusing especially on potential real estate market speculation and increased interconnection between financial institutions; possible measures to reduce and counter any negative effects of securitisation on financial stability while preserving its positive effect on financing; and the effects on the ability of financial institutions to provide a sustainable and stable funding channel to the real economy –with particular attention to SMEs.

Lastly, further power is given to the European Banking Authority to draft regulatory technical standards in a number of articles (Article 248 – exposure value and Article 255 – Determination of K_{IRB} and K_{SA}), to monitor the range of practices in the area of tranche maturity and to conduct a review with regard to significant risk transfer (both for traditional and for synthetic securitisations).

The agreed text, as well as its counterpart (Common rules on securitisation and creating a European framework for simple, transparent and standardised securitisation – 2015/0226(COD)), was approved in plenary on 26 October 2017, and subsequently by the Council on 20 November.

The final act was signed on 12 December, and published in the Official Journal on 28 December 2017. It entered into force on 17 January 2018, and will apply as of 1 January 2019.

References

Delivorias, Angelos, Synthetic Securitisation. A closer look, EPRS, June 2016.

Delivorias, Angelos, Common rules and new framework for securitisation, EPRS, January 2016.

European Commission, Impact assessment, SWD(2015)0185 final, Brussels, 30 September 2015 (SWD(2015)0186: Executive summary).

European Parliament, Legislative Observatory (OEIL), Prudential requirements for credit institutions and investment firms, Procedure file 2015/0225(COD).

Endnotes

1 The Basel III framework sets out standards and requirements for capital, risk coverage (including securitisations), containing leverage, risk management and supervision, and market discipline.

2 The BCBS framework was updated in July 2016 to include 'simple, transparent and comparable securitisations'.

3 The CRD IV/CRR package is supplemented by 32 adopted RTS (developed by the European Banking Authority – EBA), with 18 still in progress or to be launched in the future. A total of 27 adopted ITS are supplemented by two upcoming ones. The two delegated acts are: (i) a Regulation (2015/61) on the **liquidity coverage ratio** of credit institutions ('LCR Regulation'), which aims to ensure that a sufficient proportion of banking assets can be made available in the short term, and (ii) a Regulation (2014/62) covering the **leverage ratio**, to ensure that EU credit institutions and investment firms use the same methods to calculate, report and disclose their leverage ratios.

4 'In particular the eligibility criteria for securitisations as Level 2B assets in Article 13 of the LCR Delegated Act will be amended to make it consistent with the general STS criteria... .' (COM(2015)473), p. 7.

[5] 'This single hierarchy of approaches will apply to both institutions using the standardised approach (SA) or the internal ratings-based approach (IRB) for credit risk', p. 8. In order to estimate the credit risk of a bank, the Basel II regulatory framework allows banks either to use external ratings (SA) or, given specific preconditions, to use own, internal risk parameters (IRB). Risk-weighted assets Regulators then use the risk-weighted total to calculate how much loss-absorbing capital a bank needs to sustain it through difficult markets.

[6] 'Tranche maturity definition is based on the weighted-average maturity of the contractual cash flows of the tranche. Instead of calculating the weighted-average maturity an institution is allowed to choose simply to use the final legal maturity.' (COM(2015/473), p. 8. As the securitisation procedure converts loans into securities, the latter are sliced into tranches according to different levels of risk. In decreasing order of security: Senior, Mezzanine, Junior Tranche.

[7] 'The SA uses K_{SA}, that is, the capital charge for the underlying exposures under the SA, and a factor 'W', which is the ratio of the sum of the amount of all underlying pool of exposures that are delinquent to the total amount of underlying exposures.' Ibid.

[8] 'In order to qualify for this treatment the securitisation shall comply with a series of operational requirements, including applicable STS criteria. Where such transactions benefit from this type of guarantee or counter-guarantee, the preferential regulatory capital treatment that would be available to them under Regulation (EU) No 575/2013 is without prejudice to compliance with the State Aid rules.' Ibid, p 10.

[9] In order to qualify for this treatment the securitisation shall comply with a series of operational requirements, including applicable STS criteria. Where such transactions benefit from this type of guarantee or counterguarantee, the preferential regulatory capital treatment that would be available to them under Regulation (EU) No 575/2013 is without prejudice to compliance with the State Aid rules.' Ibid, p 10.

[10] For details of the Council's amendments on the parallel proposal see Delivorias, Angelos, January 2016, p. 7.

[11] The reference position is the position that is *pari passu* in all respects to the derivative or –if there is no such position– the position that is immediately subordinate to the derivative.

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