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Annex to the EBF response to the European Commission's Targeted consultation on the functioning of the EU securitisation framework

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1. Additional elaboration on responses to questions provided to the Commission consultation

This section provides additional answers to responses where the way how the questionnaire was structured did not permit to provide additional clarification. However, we consider that it is important to provide additional nuances.

Section 2:

Question 2.6:

Does the definition of private securitisation need adjustments?

-Yes

-No

-Don't know/No opinion/not applicable

Explanation:

The main question is to determine how reporting requirements for private securitisations should be amended, rather than if the definition of private securitisations should be modified. Obviously, the main objective for the EBF is the alleviation of reporting requirements (e.g. removal of any ESMA template requirement). However, should the Commission, in addition, consider an adjustment of the definition of private securitisation, the definition should be broadened based on more pragmatic criteria.

Section 6

Question 6.1:

Are there sufficiently clear parameters to assess the environmental performance of assets other than auto loans or mortgages?

-Yes, for all asset classes

-Yes, but only for some asset classes

-No

-Don't know/No opinion/not applicable

Explanation:

There are currently no clear and harmonized parameters for measuring the environmental performance of all asset classes, and standardisation in this regard should be useful. Clear and consistent parameters describing environmental performance, that are aligned with the future disclosure requirements of investor, do not exist for all asset classes (including for auto loans and mortgages) and should be developed.

The Taxonomy should be the tool against which this performance is measured, but its use should remain voluntary.

Question 6.2:

Should publishing information on the environmental performance of the assets financed by residential loans and auto loans and leases be mandatory?

- Yes, the information is currently available
- Yes, but with a transitional period to ensure the availability of information
- Yes, with a grandfathering arrangement for existing deals
- No**
- Don't know/No opinion/not applicable

Explanation:

We consider that the disclosure of ESG information covering mainstream securitisations should be voluntary, as the quality of the disclosures made by issuers/ originators are dependent on the availability and reliability of the data. In addition, the cost of obtaining the data has to be reasonable – otherwise the SECR market will be affected negatively. As the information on the underlying assets through different regulatory frameworks (i.e. SFDR, Taxonomy) may be difficult to collect initially, the operational difficulty in ensuring the provision of high-quality data and accompanying due diligence will be significant. The issuer/ originator should thus be required to comply with the current regime applying to residential loans/auto loans/leases.

We believe it makes sense to have mandatory publication of information on the environmental performance of the assets financed by residential loans and auto loans and leases **only in the case of transactions marketed as “ESG/sustainable”**. A transitional period should be granted to ensure the availability of information, coupled by a grandfathering arrangement should be found for existing deals.

We would like to remind that industry-specific standards have been developed and that additional mandatory securitisation standards overlapping industry standards would create confusion, increase costs, and have an overall negative impact on issuance.

In terms of a concrete example to underline the difficulty of obtaining data at reasonable cost, the EBF would underline auto loans and leases, where information cannot be obtained. As such, the introduction of a mandatory requirement would be harmful to the securitisation, specifically as the Energy Performance Certificate Value is not uniformly defined and currently not available in all jurisdictions of the EU. The Energy Performance Certificate Value is defined differently in almost every single European Member State. In Germany, the indication of the CO2 efficiency class shall be omitted and will no longer be available. As an alternative, it would be possible to provide information on the CO2 emissions in g per km, for vehicles from the own manufacturer or manufacturer group. However, it is not possible to provide this kind of information for vehicles from other brands given that this information is not publicly available. Currently, there is no reliable source that provides this kind of information on an individual vehicle base, i.e. based on the Vehicle Identification Number.

Question 6.5 (a):

Do you agree that these asset specific disclosures should become part of a general sustainability disclosures regime as EBA is developing?

- Yes
- No**
- Don't know/No opinion/not applicable

Explanation:

Only in cases of securitizations intended to be marketed as sustainable, and that are aligned with the EU Green Bond Standard. Duplicative disclosures and reporting frameworks should be avoided, and more defined reporting requirements should be recognized, in which availability of relevant data may be more limited.

Question 6.5 (b):

Should ESG disclosures be mandatory for (multiple choice accepted):

- Securitisation that complies with the EU Green Bond Standard

- RMBS
- auto loans/leases ABS

Explanation:

Disclosure should be mandatory only in the context of securitisation that is intended to be marketed as sustainable. In addition, the disclosure standards for the securitisation are very high and cover most of the information required by investors to perform the ESG assessment – although further treatment of ESG data in the existing ESMA templates may be merited.

2. Additional documentation on capital non-neutrality

As consistently flagged by the industry, the capital treatment of securitisation is excessively punitive, because instead of distributing the risk weighted assets across the tranches commensurately with the distribution of risk, it considerably increases the capital charge after securitisation compared to the capital charge of the loan pool before securitization.

This capital “non-neutrality” results from two factors: the supervisory ‘p’ factor which acts as an add-on (+50% for STS and +100% for non STS) and the risk-weighting floor of senior tranches (10% risk weight floor for STS positions and 15% for non-STS positions, compared to a 7% floor in the pre-STs regime).

Our position on this issue can be summarized as follows:

- Capital non-neutrality was intentionally introduced in the securitisation framework to capture agency and model risks.
- It seems fair, however, to assert that non-neutrality reaches unreasonable levels considering the improvement in banks’ models and the robust performance of EU securitisation.
- A significant recalibration of the p factor is all the more needed considering that the Basel III output floor would otherwise severely reduce the efficiency of risk-transferring securitisations. The negative consequences of the output floor are particularly worrying with regards to own account securitisations which are precisely the least exposed to agency and model risk.
- We indeed believe that both agency risk and model risk, which constitute the theoretical justification of “p” as a non-neutrality factor, need to be analyzed differently depending on the type of transactions and the role played by the banks.
- Hence a differentiated recalibration of the p factor according to the type of securitisations and their degree of exposure to agency and model risks is warranted.

- Finally, the risk-weight floors on the senior tranches should also be lowered, in line with their risk profile.

1. Capital non-neutrality was intentionally introduced in the EU securitisation framework to capture agency and model risks.

In securitisation, **agency risk** is the operational risk arising from the multiple relationships between the different agents of a securitisation structure, and related information asymmetries as well as potential misalignment of interests. **Model risk** arises from the layering of models and assumptions made on the underlying pool and on transaction structural features to estimate the loss distribution which serves to define the waterfall of tranches.

BCBS papers issued in 2012 and 2014¹ – i.e. at a time when internal models were under regulator's suspicion – explicitly point out to model risk when explaining the rationale for the p factor and RW floors: they highlight the need to “mitigate concerns related to incorrect model specifications and error from banks’ estimates of inputs to capital formulas (i.e. model risk), and reduce the variation in outcomes for similar risks.”

Regulation 2017/2401, which introduced the current p factors and RW floors on senior tranches, refers explicitly to “misalignment between the interests of investors and originators (‘agency risks’)” as a justification for a more conservative capital treatment for securitisation.

2. It seems fair, however, to assert that capital non-neutrality reaches unreasonable levels considering the improvement in banks’ models and the robust performance of EU securitisation.

Capital non-neutrality varies under both internal models (SEC-IRBA) and standardized models (SEC-SA) depending on asset quality and granularity of the pool, but consistently reaches very high levels. For instance, for SEC-IRBA STS transactions, the “pre-securitisation v. post-securitisation RW multiple” ranges from 1.3 (high-yield corporates) to 4 (residential mortgages with 80% LTV). For SEC-SA STS transactions, this range goes from 1.5 (corporates, consumer loans) to 2.4 (residential mortgages with 100% LTV). This multiple is even higher for non-STs transactions, either under SEC-IRBA or SEC-SA. Please refer to appendix 1 for detailed simulations on different portfolios.

Such levels of capital non-neutrality are most problematic for banks retaining (large) senior securitisation tranches, which is typically the case with synthetic on-balance sheet transactions, where by definition the originating bank retains the senior tranche, but also in most cash transactions (banks typically retain most of the senior tranche to the extent authorized by the JSTs to obtain SRT recognition): due to non-neutrality factors, senior tranches attract between c. 25% and c. 50% of the total risk-weight of the securitization transaction, although they support only a minimal share of the risk (less than 1%).

Since the 2012 & 2014 BCBS papers, the justification for capital non-neutrality based on model risk has lost much of its relevance. Indeed, a number of EU initiatives such as EBA’s IRB repair, ECB TRIM, model risk management frameworks and capital attributed to model risk, as well as forward-looking yearly stress tests, have largely mitigated model risk, which will be further addressed by the input floors specified in the final Basel rules. Also, in the case of securitisations aiming at risk transfer, the SRT

¹ BCBS, Revisions to the securitisation framework, December 2012 and December 2014.

assessment process performed with Competent Authorities consists in a thorough review of the transaction, which allows a precise understanding of the modelling.

In addition, the conservatism of the EU securitisation prudential framework is not supported by performance, which has proved much better in Europe than in the US since 2008 (please refer to appendix 2).

3. A significant recalibration of the p factor is all the more needed considering that the final Basel III rules would otherwise severely reduce the efficiency of risk-transferring securitisation transactions.

Basel III impact studies have not properly addressed the introduction of the new securitisation framework and the unintended effects of the application of an output floor based on Standard RWA. When simulating the impact on own account Securitisation structures covering IRB portfolios, we can observe that although they are efficiently structured to release RWA under the SEC-IRBA, they are totally inefficient or even worsening the effects of the output floor because of the conservative calibration of the SEC-SA which has been designed before the introduction of the output floor.

The reason why securitisation is more affected by the output floor vs. other asset classes is that the floor plays twice in a securitisation transaction and that these effects are compounded. The first layer of conservatism introduced by Basel III affects the pool's RWA used in the calculation of the risk-weight on retained tranches: these RWA are indeed floored to the SA and may thus be higher than under the IRBA. The second impact results from the application of the SEC-SA, which is more conservatively calibrated than the SEC-IRBA: all things equal, the SEC-SA will lead to a (much) higher capital charge.

The consequences of the output floor are particularly worrying with regards to own account securitisation, either synthetic/on-balance sheet (where by definition the senior tranche is retained), or cash (banks typically retain most of the senior tranche to the extent authorized by the JSTs to obtain SRT recognition).

Simulations on several corporate portfolios (STS, non-STs, with different maturities and risk parameters) evidence that **halving the p factor (adjustment of the p-factor for SEC-SA to 0.5 for non-STs and to 0.25 for STs) would partially offset this very negative impact (by around 50%)**. Please refer to appendix 3 for more details on the impact of the output floor and how it can be mitigated.

4. Agency risk and model risk need to be analyzed differently depending on the type of transactions and on the role played by the banks.

In our view, important distinctions should be made between three categories of securitisation exposures which are not exposed to the same levels of agency and model risk:

- a) "Own account securitisation": the bank has originated securitisation assets (synthetic on-balance sheet securitisations, some public securitisations);
- b) Client private funding through either balance sheet or ABCP conduit: the bank qualifies as "investor" under the SECR but rather acts as a bank extending a credit to a client (viewed as "originator" under the SECR).
- c) Other cases: typically, when the bank invests in public securitisation tranches.

Own account securitisation

In the case where the originator of the securitisation transaction has also originated the assets, it has an intimate knowledge of the assets and often continues to service them (all synthetic securitisations and the vast majority cash securitisations). Second, it often structures or participates actively to the structuration of the transaction to ensure it matches its requirements. The originating bank is usually either directly arranging the transaction or designing the transaction model or mandates an arranger to do it with close involvement. Third, it is in position to reassess and update on a continuous basis all the input parameters of the SEC IRBA if under the advanced approach. If the bank is using the standard approach and SEC-SA, the bank is not relying on any internal estimates or models. Fourth, it has the same supervisor on both the underlying assets and the securitisation positions: any alert or action initiated by the originator's supervisor on the underlying asset would automatically be transposed in the securitised positions. Finally, the originator is responsible for the reporting of the transaction to all the parties in the transaction.

In brief, there is close to zero agency risk and model risk involved for the originator in own account securitisation.

Private Client funding through balance sheet or ABCP

Such client funding is at the very core of the business of banking and banks can rely on all their client knowledge, credit expertise and infrastructure to assess and monitor the risks involved. ABCP sponsor banks or banks providing warehousing or term funding to clients in Securitisation format have direct banking relationship with the clients/originators. They have regular contact with the clients, perform extensive due diligence and can have access to all the information they need to analyze the risks, without the limitations that exist in public deals where all investors have to receive the same level of information. Thus banks have first-hand knowledge of the credit risk of the pool of assets and constantly monitor the performance of the assets and transaction; they also initiate and/or structure the transaction to match their credit criteria and are thus fully aware of the legal documentation as well as the transaction model. They also design with the client the transaction reporting.

In all these transactions, there is usually zero reliance on rating agencies as the transaction are in most cases not externally rated. Instead, the banks do their own internal rating analysis and stress testing with the usual checks and challenges done by the Risk team as second line of defense.

In brief, given the client knowledge, direct access to the client and information to perform due diligence, intimate knowledge of the structure and models, the non-reliance on rating agency and internal credit expertise, both agency and model risks are very limited in the private market of banks funding their clients through securitisation. In addition, banks typically provide funding at the senior level where there is much less exposure to any potential agency or model risks which would typically hit first the junior tranches which are retained by the clients.

Investment in public transactions

Contrary to own account securitisation or private client funding where agency risk is nil or very limited, investors in public securitisations are still exposed to agency risk given the limited time to conduct their due diligence, no direct relationship with the originator and no involvement in the structuring of the transaction as well as some degree of reliance on the rating agencies. However, retention, due diligence requirements and transparency rules have significantly reduced agency risk for public investors since the GFC.

5. A differentiated recalibration of the p factor according to the type of securitisations and their degree of exposure to agency and model risks is warranted.

For the reasons stated above, one can however reasonably assert that:

- the degree of uncertainty in the calculation of capital requirements for securitisations resulting from agency and model risks is considerably reduced with own account securitisation transactions that obtain SRT recognition and with private client funding under securitisation format; while
- agency risk persists in some other cases, such as investments in public securitisation tranches, although it is significantly reduced thanks to the retention rules and disclosure requirements.

This is why we advocate for a recalibration of the p factor that would both:

- recognize and reflect the different degrees of exposure of retained tranches to agency and model risks, while maintaining some level of non-neutrality to address the residual degree of uncertainty in the calculation of capital requirements for securitisations; and
- largely address the impact of the output floor on retained securitisation exposures.

As a consequence of the above, we believe the p factor should be revised taking into account the following principles:

- Under SEC-SA, own account securitisation, either under cash or synthetic format, and whether the transaction is STS or non-STS, should benefit from “p” factors significantly below 0.5.
- Under SEC-SA, private client funding under securitisation format should benefit from “p” factors below 0.5 but greater than the ones applying to own account securitisation.
- Under SEC-IRBA, the p factor floor should be suppressed for own account and private client funding (whether the transaction is STS or non-STS); the maxima should be more significantly reduced for own account than for private client funding.
- Both under SEC-SA and SEC-IRBA, p factors should be reduced for other securitisation exposures, although to a lesser extent than for own account and private client funding.

6. The risk-weight floors on the senior tranches should also be lowered, in line with their risk profile.

For recalibration proposals, please refer to our response for question 9.2, which is in line with the recommendations made by the High-Level Forum on the Capital Markets Union.

Supporting information – Capital non-neutrality in STS and non-STS transactions under SEC-IRBA and SEC-SA

	<u>SEC-IRBA STS</u>
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			<u>Corporate</u>	<u>Corporate (high yield)</u>	<u>Residential Mortgage (LTV=80 %)</u>	<u>Residential Mortgage (LTV=100%)</u>	<u>Consumer loans</u>
<u>Maturity (years)</u>			<u>2.5</u>	<u>5</u>	<u>5</u>	<u>5</u>	<u>5</u>
<u>Probability of Default</u>			0.10%	1%	0.10%	0.50%	1.00%
<u>Loss Given Default</u>			45%	45%	15%	15%	50%
<u>Granularity</u>			400	400	10 000	10 000	10 000
<u>Unexpected loss</u>			2.51%	8.37%	0.02%	0.08%	4.31%
<u>Risk-Weight applicable to securitised pool under A-IRB (1)</u>			31%	105%	4%	12%	54%
<u>Attachment point</u>	<u>Detachment point</u>	<u>Tranche thickness</u>	<u>RW</u>				
0%	1%	1%	1250%	1250%	515%	1250%	1250%
1%	8%	7%	416%	1250%	10%	69%	1043%
8%	100%	92%	10%	43%	10%	10%	13%
<u>Risk-Weight applicable to aggregate tranches after Securitisation (2)</u>			51%	140%	15%	27%	97%
<u>RW Multiplier (2)/(1)</u>			1.6	1.3	4.0	2.1	1.8

<u>SEC-SA STS</u>						
	<u>Corporate</u>	<u>Corporate (high yield)</u>	<u>Residential Mortgage (LTV=80 %)</u>	<u>Residential Mortgage (LTV=100 %)</u>	<u>Consumer loans</u>	
<u>Risk-Weight applicable to securitised pool under SA (1)</u>	100%	103%	35%	48%	75%	
<u>Attachment point</u>	<u>Detachment point</u>	<u>Tranche thickness</u>	<u>RW</u>			

0%	1%	1%	1250%	1250%	1250%	1250%	1250%
1%	8%	7%	1250%	1250%	565%	1170%	1154%
8%	100%	92%	54%	101%	10%	23%	21%
Risk-Weight applicable to aggregate tranches after Securitisation (2)			150%	193%	61%	116%	112%
RW Multiplier (2)/(1)			1.5	1.9	1.8	2.4	1.5

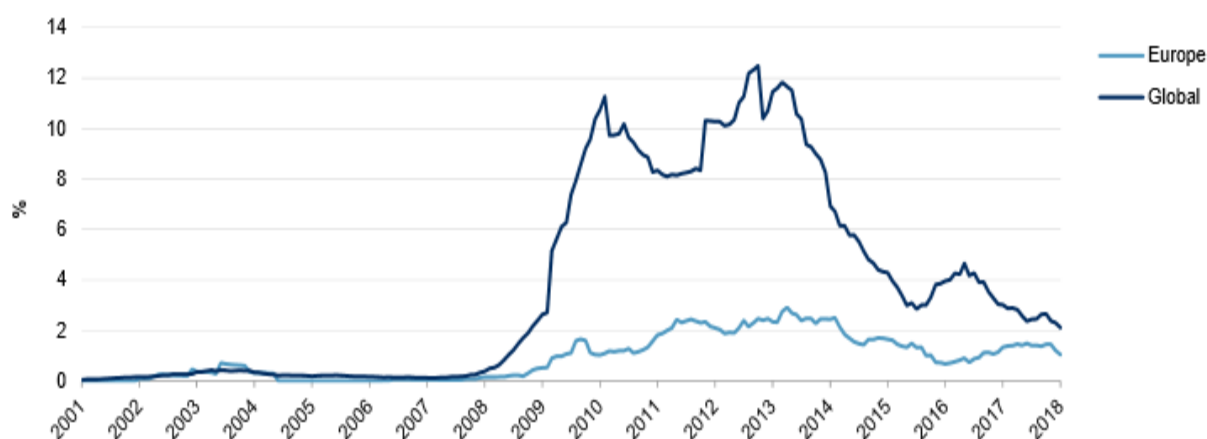
			SEC-IRBA non-STs				
			Corporate	Corporate (high yield)	Residential Mortgage (LTV=80%)	Residential Mortgage (LTV=100%)	Consumer loans
Maturity (years)			2.5	5	5	5	5
Probability of Default			0.10%	1%	0.10%	0.50%	1.00%
Loss Given Default			45%	45%	15%	15%	50%
Granularity			400	400	10 000	10 000	10 000
Unexpected loss			2.51%	8.37%	0.02%	0.08%	4.31%
Risk-Weight applicable to securitised pool under A-IRB (1)			31%	105%	4%	12%	54%
Attachment point	Detachment point	Tranche thickness	RW				
0%	1%	1%	1250%	1250%	835%	1250%	1250%
1%	8%	7%	465%	1250%	17%	16%	1130%
8%	100%	92%	15%	53%	15%	15%	45%
Risk-Weight applicable to aggregate tranches after Securitisation (2)			59%	148%	23%	27%	133%
RW Multiplier (2)/(1)			1.9	1.4	6.2	2.2	2.5

			SEC-SA non-STs				
			Corporate	Corporate (high yield)	Residential Mortgage	Residential Mortgage (LTV=100%)	Consumer loans

			(LTV=80%)		
Risk-Weight applicable to securitised pool under SA (1)	100%	103%	35%	48%	75%
Attachment point	Detachment point	Tranche thickness	RW		
0%	1%	1%	1250%	1250%	1250%
1%	8%	7%	1250%	1250%	743%
8%	100%	92%	109%	171%	15%
Risk-Weight applicable to aggregate tranches after Securitisation (2)	200%	257%	78%	154%	150%
RW Multiplier (2)/(1)	2.0	2.5	2.2	3.2	2.0

Supporting information – The conservatism of the EU prudential framework is not supported by performance, which has proved much better in Europe than in the US

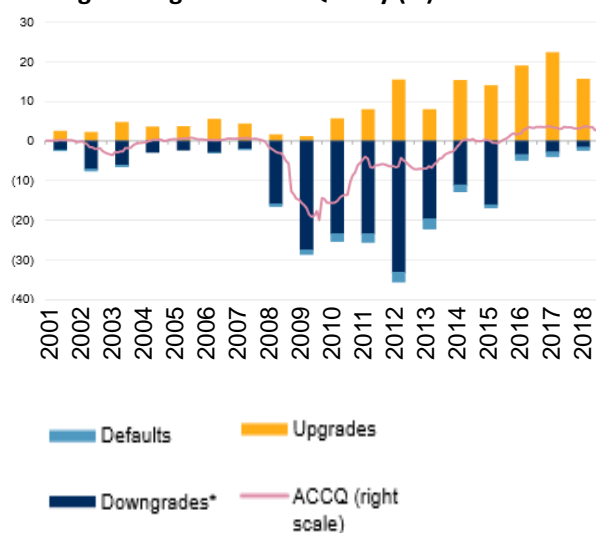
European Structured Finance 12-Month Trailing Default Rates



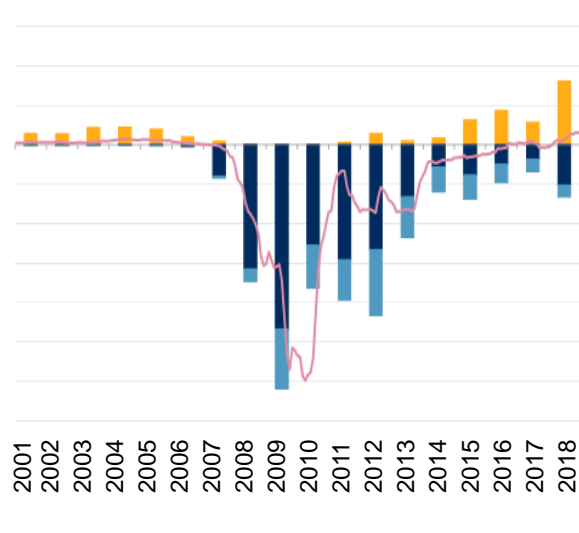
Source: S&P Global Fixed Income Research.

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European Structured Finance Transition Rates and Average Change in Credit Quality (%)



US RMBS Transition Rates and Average Change in Credit Quality (%)

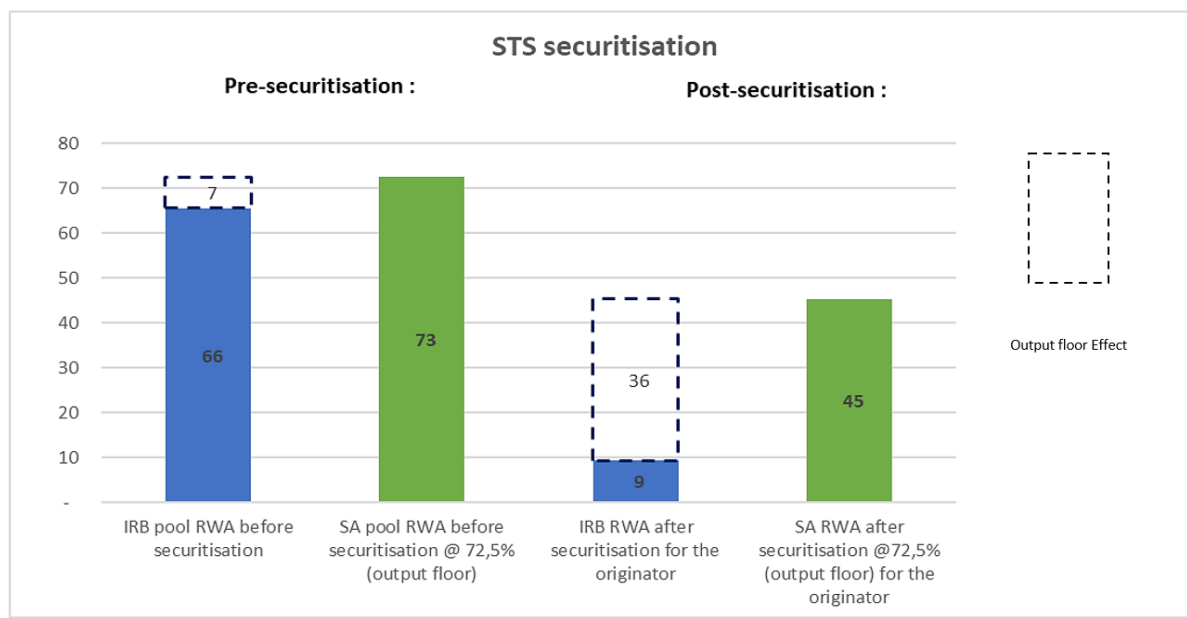


*Excluding defaults. ACCQ--Average change in credit quality. Securities whose ratings migrated to 'NR' over the period are classified based on their rating prior to 'NR'. Source: S&P Global Fixed Income Research.

Supporting information – The consequences of the final Basel III rules on securitisation efficiency should be duly addressed

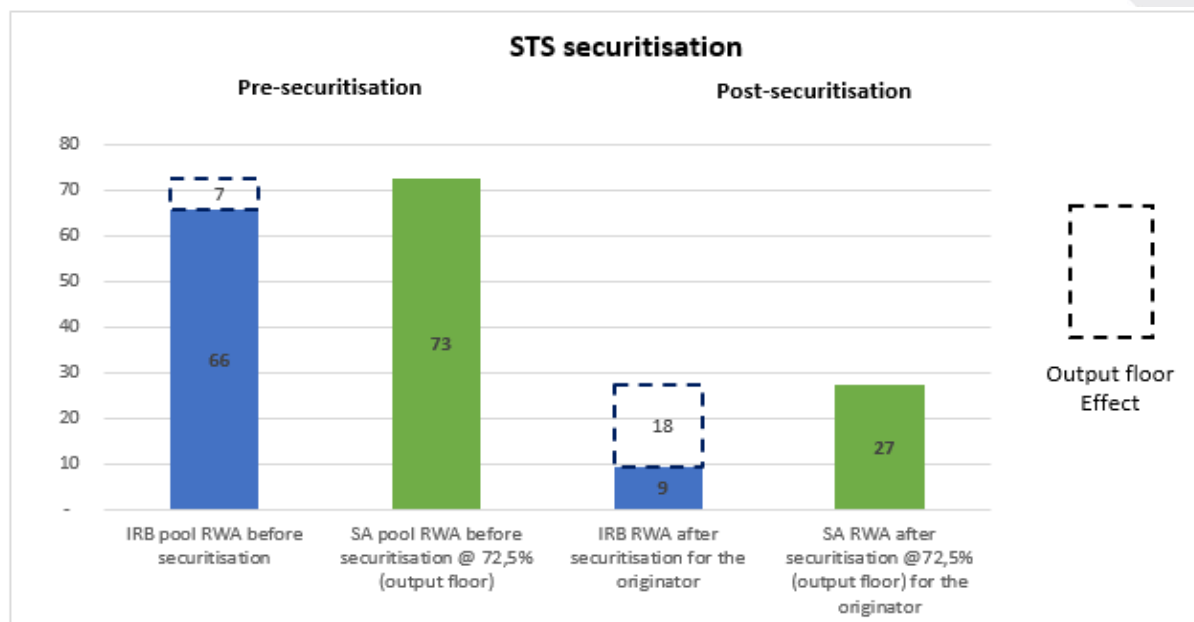
Case studies: p-factor impacts on the SEC-SA and the output floor

- STS transaction: impact under current “p” factor



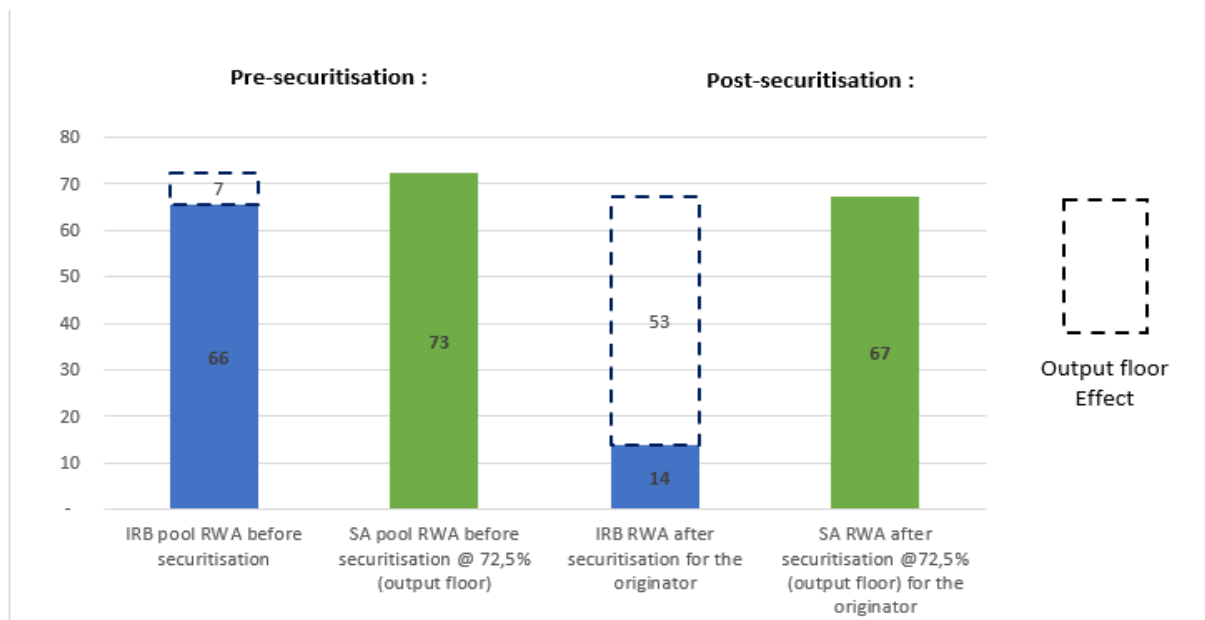
Example of a corporate pool eligible to the SME supporting factor, attracting 66 RWA under IRBA and 100 RWA under SA (2.5y-maturity, 0.5% PD, 40% LGD) : the output floor impact before securitisation is +7 on the pool (i.e., the difference between the 73 RWA post SME supporting factor and 66 RWA under IRBA), but the impact on the retained senior tranche after securitisation is +36 (i.e., 45 under SEC-SA minus 9 under SEC-IRBA) in the case of an STS transaction. The STS transaction **would have released 57 RWA** (66 RWA on the underlying portfolio under IRBA minus 9 RWA on the retained senior tranche risk-weighted under SEC-IRBA), but **will only release 28 RWA** with the output floor (73 RWA on the underlying portfolio under SA minus 45 RWA on the retained senior tranche under SEC-SA).

- [STS transaction: impact under revised “p” factor](#)

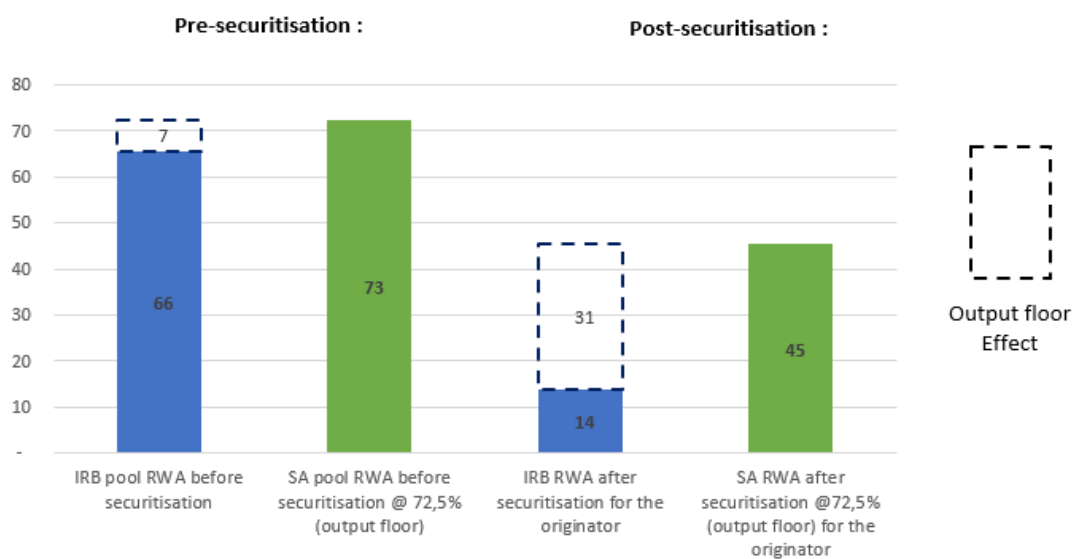


- Applying a p parameter under SEC-SA from 0.5 to 0.25 to STS securitisation will reduce the output floor effect by half.

- [Non-STs transaction: impact under current “p” factor](#)



- Non-STIS transaction: impact under revised "p" factor



- Applying a p parameter under SEC-SA from 1 to 0.5 to non-STIS securitisation would reduce the output floor effect by 44%.

3. Additional documentation on the PBA test for the SRT

As is explained in the consultation response, the PBA test ensures that at least 50% of the unexpected loss ("UL") of the underlying exposures is transferred to third parties i.e. that the mezzanine tranche sold is thick enough. We deem this requirement unnecessary as institutions use SRT securitisation to release a minimum amount of RWA, which would not be achieved if the only mezzanine tranche is too thin: indeed, in such case, the non-neutrality of the securitisation risk weighting frameworks makes any capital relief impossible. We quantitatively illustrate on a synthetic securitisation, where only the mezzanine tranche is transferred (very common situation for synthetic securitisation), that a too thin mezzanine tranche either does not create any RWA relief (although a small part of the UL is transferred) or generates a non-significant amount of RWA relief with thus no interest for the originating bank to mobilize internal and external resources (lawyer, servicer) and pay the cost to investors, for such a limited risk transfer and capital benefit.

Pool's characteristics	
PD	0,20%
LGD	45%
M	5
Granularity	500
RW	71%
RWA pool	71,03
UL	5,68%

Case study 1: Thick (7,7%) mezzanine sold to investors					
		RW SEC - IRBA	Detachment	Tranche RWA	RWA Retained tranches
Retained	Senior	15,00%	100,00%	13,70	13,70
Sold	Mezzanine	1085,35%	8,70%	83,57	<i>sold</i>
Retained	Equity	1250,00%	1,00%	12,50	12,50
	Total				26,20
Proportion of RWA released					63,12%
Proportion of total UL transferred to third parties					82,40%

Case study 2: Thin (4,7%) mezzanine sold to investors					
		RW SEC-IRBA	Detachment	Tranche RWA	RWA Retained tranches
Retained	Senior	15%	100%	13,70	13,70
Sold	Mezzanine	980%	8,7%	46,07	<i>sold</i>

Retained	Equity	1250%	4,0%	50,00	50,00
	Total				63,70
Proportion of RWA released					10,33%
Proportion of total UL transferred to third parties					29,61%

Case study 3: Very thin (1%) mezzanine sold to investors					
			Detachment	Tranche RWA	RWA Retained tranches
Retained	Senior	30%	100%	27,89	27,89
Sold	Mezzanine	1153%	6,5%	11,53	<i>sold</i>
Retained	Equity	1250%	5,5%	68,75	68,75
	Total				96,64
Proportion of RWA released (additional RWA)					-36,05%
Proportion of total UL transferred to third parties					0,18%