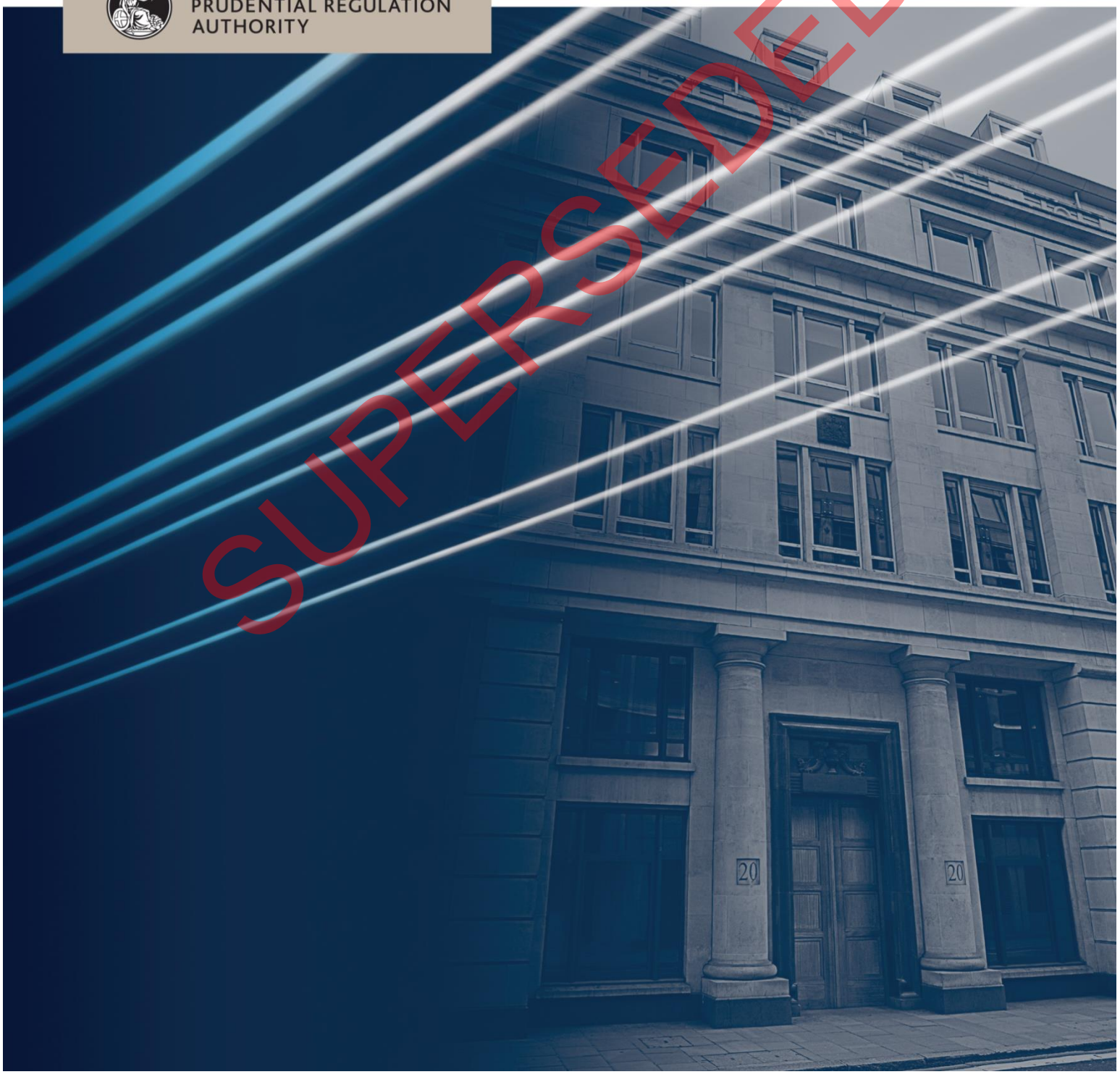
Supervisory Statement | SS10/18

Securitisation: General requirements and capital framework

November 2018

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY



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Prudential Regulation Authority | 20 Moorgate | London EC2R 6DA

Contents

1 Introduction

1.1 This supervisory statement (SS) sets out the Prudential Regulation Authority's (PRA's) expectations of firms in respect of securitisation in the following chapters:

- 'General requirements under the Securitisation Regulation' (Chapter 2) – general expectations of firms and processes under Chapter 2 of the Securitisation Regulation.

- 'STS ABCP Sponsors' (Chapter 3)- general expectations of firms seeking to become sponsors of Simple, Transparent and Standardised (STS) Asset Backed Commercial Paper (ABCP) programmes.

- 'CRR securitisation capital framework' (Chapter 4) - PRA expectations and approach as regards the securitisation capital framework for firms to which Directive 2013/36/EU (CRD) applies.

1.2 This statement is relevant to PRA-authorised CRD IV firms and PRA-authorised Solvency II firms to which the Securitisation Regulation applies unless stated otherwise.[1] This includes PRA-authorised UK banks, building societies, PRA-designated UK investment firms, UK insurance firms, UK reinsurance firms and UK insurance special purpose vehicles (ISPVs).

2 General requirements under the Securitisation Regulation

2.1 This chapter is relevant to PRA-authorised CRD IV firms and PRA-authorised Solvency II firms to which the Securitisation Regulation applies.

Originator, original lender, and sponsor requirements

General requirements

2.2 The PRA expects firms which act as originators, original lenders, and/or sponsors in a securitisation that are subject to the requirements of the Securitisation Regulation to be able to demonstrate to the PRA, on request, that they have in place adequate arrangements, processes and mechanisms in order to comply with Articles 6, 7, 8 and 9 of the Securitisation Regulation.

2.3 A firm should inform its supervisor if it anticipates material change in its securitisation activity as an originator or sponsor. That includes, engaging in securitisation issuance for the first time, securitising an asset class for the first time, or significantly increasing the amount of issuance.

Governance arrangements, processes and mechanisms

2.4 Where a firm acts as an originator, original lender, and/or sponsor in a transaction subject to the requirements of the Securitisation Regulation, the PRA expects the firm's internal audit function to provide assurance that the firm's involvement in the securitisation is compliant with the requirements in Articles 6, 7, 8 and 9 of the Securitisation Regulation.

2.5 The PRA expects that relevant individuals performing Senior Management Functions (SMFs), such as the individual to whom Prescribed Responsibility (PR) 7 has been allocated, exercise effective oversight of securitisation issuance, including with regard to the

1 Regulation (EU) 2017/2402 of the European Parliament and Council of 12 December 2017, laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, and amending Directives 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012.

requirements in Article 6(2) on adverse selection. Where appropriate, the PRA expects SMFs to escalate issues related to oversight of securitisation issuance to the board or a relevant sub-committee.

Insurance firms, reinsurance firms or ISPVs as originators

2.6 The PRA considers that insurance, reinsurance firms or ISPVs can be originators within the meaning of Article 2(3) of the Securitisation Regulation. Articles 2(12)(a) and (b) of this regulation makes clear that insurance or reinsurance undertakings can also be 'institutional investors' in securitisation. The PRA expects insurance and reinsurance firms, and ISPVs, to consider whether any transactions, such as those that aim to refinance loans, exposures or receivables by transforming them into tranched securities and including any internal restructurings, may be considered securitisations as defined in Article 2(1) of this regulation. The Securitisation Regulation imposes a set of requirements on investors, originators, sponsors, and securitisation special purpose entities (SSPEs) with which they are required to comply.

2.7 Insurance or reinsurance firms can be both originators and investors in the same securitisation transaction, such as an internal restructuring of exposures or receivables for capital efficiency or matching adjustment (MA) eligibility purpose. In such cases the insurance or reinsurance firm must comply with Articles 6, 7, 8 and 9 of the Securitisation Regulation as applicable. Where an insurance firm, reinsurance firm, or ISPV identifies itself as the originator of a securitisation, it should inform its supervisor without undue delay.

2.8 Where the originator is also the sole investor in the transaction, the PRA expects that the firm may consider the information specified in Article 7(1)(a) and (e) as 'made available' to investors through internal reporting to appropriate committees or the management board, provided the reporting contains the required information.

Investor requirements

2.9 The PRA expects institutional investors that invest in securitisation to be able to demonstrate on request that they have in place adequate due diligence arrangements, processes, and mechanisms to ensure compliance with Article 5 of the Securitisation Regulation. The level and nature of investor due diligence prior to holding a securitisation position may be proportionate to the risks of the securitisation position, provided they comply with the requirements of Article 5.

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

3 STS ABCP sponsors

3.1 This chapter is relevant to PRA-authorised CRD IV credit institutions.

3.2 A credit institution supervised under CRD IV may act as a sponsor for an STS ABCP programme using one of the following routes:

(i) the credit institution demonstrates to its competent authority that the support it provides to the programme would not endanger its solvency and liquidity, even in an extreme market stress (Article 25(3), subparagraph 1); or

(ii) the competent authority has determined on the basis of the review and evaluation referred to in CRD Article 97(3) that the arrangements, strategies, processes, and

mechanisms implemented by that credit institution and the own funds and liquidity it holds ensure the sound management and coverage of its risks (Article 25(3) subparagraph 2).

3.3 The PRA is the competent authority for the purposes of Article 25(3) with respect to PRA-authorised CRD IV credit institutions.

Article 25(3) subparagraph 1

3.4 To demonstrate to the PRA that its role as an STS ABCP Sponsor under Article 25 of the Securitisation Regulation will not endanger its solvency or liquidity, a firm should notify its usual supervisory contact, providing relevant information that should include:

(i) an assessment of the impact of full support on the firm's Total Capital Requirement on an individual and consolidated basis, both with and without STS status;

(ii) an assessment of the impact of full support on the firm's regulatory liquidity guidance and buffer resources, both with and without STS status; and

(iii) a summary of the programme features relevant to an understanding of the assessment in (i) and (ii) above, including an assessment against STS requirements in Articles 25 and 26 of the Securitisation Regulation.

3.5 Where a firm seeks to set up a new conduit, or is proposing to sponsor an ABCP programme or transaction for the first time, it must provide its supervisors with the request sufficiently in advance of the execution of the transaction.

Article 25(3) subparagraph 2

3.6 For the purposes of being an STS ABCP sponsor, the PRA is unlikely to determine on the basis of the review and evaluation referred to in CRD Article 97(3) that the arrangements, strategies, processes, and mechanisms implemented by that credit institution and the own funds and liquidity it holds ensure the sound management and coverage of its risks, unless the firm is currently a sponsor for at least one ABCP programme. This may include any existing non-STS ABCP programme for which the firm wishes to seek STS status.

3.7 Where a firm seeks to make use of the route specified in Article 25(3) subparagraph 2, it should make a written request to its usual supervisory contact prior to, or alongside, the submission of either its internal capital adequacy assessment process (ICAAP) or internal liquidity adequacy assessment process (ILAAP) document. Where the information specified in paragraph 3.5 is not already available in the ICAAP or ILAAP document, the firm should also provide necessary information referenced in paragraph 3.5.

4 The CRR securitisation capital framework

4.1 This chapter is relevant to PRA-authorised CRD IV firms. It sets out the PRA's expectations of firms in respect of the CRR securitisation capital framework in the following sections:

(i) 'Hierarchy of methods' –with respect to the exercise of discretions which determine the methods applied for calculating securitisation Risk Weighted Exposure Amounts (RWEAs).

(ii) 'Interim mapping of External Credit Assessment Institutions (ECAIs) structured finance credit assessments to Credit Quality Steps (CQS)' — with respect to the interim mapping of rating agency grades to CQS for the purposes of securitisation positions risk weighted under the External Ratings Based Approach (SEC-ERBA).

Hierarchy of methods

PRA discretions under the hierarchy of methods

4.2 CRR Article 254 introduces the hierarchy of methods for calculating securitisation RWEAs, summarised below:

(i) where the conditions set out in Article 258 are met, the Securitisation Internal Ratings Based Approach (the 'SEC-IRBA') in accordance with Articles 259-260;

(ii) where the SEC-IRBA may not be used, the Securitisation Standardised Approach (the SEC-SA) in accordance with Article 261-262; and

(iii) where the SEC-SA may not be used, the Securitisation External Ratings Based Approach (the 'SEC-ERBA') in accordance with Articles 263-264 for rated positions or positions in respect of which an inferred rating may be used.

4.3 Under CRR Articles 254(4) and 258(2), the PRA may use the following discretions, on a case-by-case basis to:

(i) prohibit firms from applying SEC-SA, when the risk-weighted exposure amount resulting from the application of the SEC-SA is not commensurate with the risks posed to the institution or to financial stability; and

(ii) prohibit the use of SEC-IRBA where securitisations have highly complex or risky features.

4.4 The PRA intends to use these discretions in order to support its primary objective of maintaining the safety and soundness of firms. Although the PRA does not favour any single method, in some cases Pillar 1 capital requirements arrived at under the SEC-ERBA may be a more appropriate reflection of risk to the firm than those arrived at under the SEC-SA or SEC-IRBA. When considering an exercise of its discretions, the PRA will take into account, among other things, the aggregate impact on a firm's overall capital requirements. The PRA does not expect firms to solicit ECAI ratings for all of their securitisation positions.

4.5 When determining whether to exercise its discretion under Articles 254(4) and 258(2), the PRA will consider whether securitisations a firm is exposed to exhibit features which are not explicitly captured in the SEC-SA or SEC-IRBA methods. The PRA may also consider the appropriateness of underlying credit risk weights for the portfolio as reflected in the K_{SA} or K_{IRB} determined under Article 255.

4.6 The SEC-IRBA is sensitive to a wider range of inputs than the SEC-SA. Therefore where the presence of a highly complex or risky feature leads the PRA to exercise its discretion to preclude the use of the SEC-IRBA, the PRA is also likely to prohibit the use of the SEC-SA on the grounds that the risk weights under the SEC-SA are not commensurate with the risks posed to the institution.

4.7 The SEC-SA and SEC-IRBA methods can only recognise a defined number of items in their calculation of capital requirements, primarily focused on credit risk. These methods may fail to recognise the presence of non-credit risks. To an extent some additional non-credit risks which can arise from securitisation are reflected in the 'non-neutrality' of the securitisation capital

framework.[2] However the level of non-neutrality is driven by pre-defined inputs (eg STS status).

4.8 When the SEC-SA or SEC-IRBA method is applied to a securitisation position, there is also a risk that the K_{SA} or K_{IRB} derived using the credit risk capital framework is inappropriate. This may be because the underlying exposures are affected by risk drivers which are not adequately captured by the credit risk framework.

4.9 In the presence of risk characteristics and structural features which are not explicitly captured in the formulas of the SEC-SA or SEC-IRBA, including features not adequately captured in the underlying credit risk framework, it is possible that an appropriate assessment by an ECAI takes into account those features. In such cases the SEC-ERBA may more appropriately reflect the risk posed to the institution.

4.10 Examples of features or characteristics which expose firms to risks not captured in the SEC-SA or SEC-IRBA include, but are not limited to, those listed in Article 258(2)(a) to (d), and:

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

(b) features or characteristics which expose holders of securitisation notes to the risk that market conditions at the date of the sale or refinance of underlying exposures result in losses, such as exposure to residual value risk;

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

(d) portfolios where the underlying exposures may be highly correlated in the event of a stress;

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

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

4.11 The PRA, in conjunction with the Financial Policy Committee (FPC) or on its own initiative, may identify financial stability risks arising from firms' securitisation activity. Where the RWEA calculated under the SEC-SA method is not commensurate with the risk posed to financial stability, the PRA may mitigate the risk by use of Article 254(4).

Information on methods used by firms

4.12 The PRA expects firms to have regard, during their ICAAP, to the provisions in SS31/15 paragraphs 2.39 and 2.40.[3] The PRA will monitor possible risks to safety and soundness with reference to Common Reporting (COREP) and a firm's ICAAP document. The information provided in a firm's ICAAP document, supplemented by information received by other means

2 'Non-neutrality' of the framework here means that typically the total RWEAs calculated for the tranches of a securitisation will be higher than the RWEAs calculated for the underlying portfolio had it not been securitised. In the SEC-SA and SEC-IRBA, this non-neutrality is introduced primarily through the application of a risk weight floor (10% for STS positions and 15% for non-STS positions) and the supervisory 'p' factor.

3 'The Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP)', April 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/the-internal-capital-adequacy-assessment-process-and-supervisory-review-ss.

such as regulatory reporting, will be used to assist the PRA in its assessment of whether firms' securitisation exposures using the SEC-SA or SEC-IRBA are appropriately capitalised.

4.13 The PRA may request additional information in order to evaluate whether Pillar 1 capital requirements appropriately reflect the risk posed to an institution. The PRA expects firms to provide this information within 30 business days, unless agreed otherwise.

4.14 This additional information may vary on a case-by-case basis, but should include:

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

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

- the asset class of the underlying securitised exposures;
- the risk characteristics and structural features exhibited by the securitisation that may materially impact the performance of the firm's securitisation position, and which are not explicitly taken into account by the method applied;
- unless already provided in the most recent Common Reporting (COREP) submission:[4]
  - for positions risk-weighted under the SEC-IRBA, the risk-weighted exposure amount for that securitisation position under the SEC-IRBA, SEC-ERBA (for rated positions only) and SEC-SA insofar as each method can be used; or
  - for rated positions risk-weighted under the SEC-SA, the risk-weighted exposure amounts for that securitisation position under the SEC-ERBA.
- a hyperlink to the prospectus of the transaction, or where no prospectus is available a copy of the offering circular or equivalent; and
- for rated securitisation positions, the latest rating(s) attributed to the position and the ECAI(s) which provided that rating.

Communication of decisions on the hierarchy of methods

4.15 Where the PRA considers that the exercise of its discretion under Articles 254(4) or 258(2) is justified, it will inform the firm in writing.

4.16 The PRA may choose to exercise one or both of the discretions under Articles 254(4) and 258(2) in respect of a securitisation position or a defined group of securitisation positions.

4.17 The PRA may choose to exercise the discretion under Article 254(4) to an unrated securitisation position for which a rating may not be inferred, in which case it may require the firm to apply a 1,250% risk weight to the securitisation position.

Firms' use of the CRR hierarchy

4.18 Relevant senior management should ensure that firms are using appropriate methods to capitalise their securitisation exposures.

4 Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council, as amended from time to time.

4.19 For these purposes, relevant senior management means the individual(s) performing the relevant SMF(s), and employees subject to the Certification Regime involved in investment decisions in securitisation exposures (eg relevant Material Risk Takers (MRTs) under the Remuneration rules).

4.20 Under Article 254(3), firms may decide to apply the SEC-ERBA instead of the SEC-SA to all of their rated securitisations or positions in respect of which an inferred rating may be used.

4.21 Firms should notify the PRA of a decision made under CRR Article 254(3). That notification should be sent simultaneously by email to securitisation.hierarchy@bankofengland.co.uk and to the firm's usual supervisory contact. This notification should include information on the impact of such a decision on the firm's securitisation RWEAs.

Interim mapping of External Credit Assessment Institutions (ECAIs) structured finance credit assessments to Credit Quality Steps (CQS)

4.22 CRR Article 270(e) requires the European Banking Authority (EBA) to produce Implementing Technical Standards (ITS) mapping the credit assessments of ECAIs to the CQS specified in the CRR for the purposes of calculating risk-weighted exposure amounts under the SEC-ERBA.[5]

4.23 Prior to adoption of this ITS, the PRA expects firms to use the illustrative Basel securitisation ERBA mapping for long-term ratings,[6] as set out in Table 1 below for long-term ratings. For short-term ratings, PRA expects firms to use the existing short-term mapping in Commission Implementing Regulation (EU) 2016/1801 on laying down technical standards with regard to the mapping of credit assessments for securitisation. These tables will be superseded once the relevant ITS has been adopted.

Table 1: Long-term ECAI assessment mapping

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

5 For ECAI credit assessments used in respect of retained tranches in a significant risk transfer (SRT) securitisation, see paragraph 4.3 of SS9/13 'Securitisation: Significant Risk Transfer', November 2018: https://www.bankofengland.co.uk/prudential-regulation/publication/2013/securitisation-ss.

6 Basel, July 2016, 'Revisions to the Securitisation Framework'. The rating designations referenced are for illustrative purposes only and do not indicate any preference for, or endorsement of, any particular external assessment system.