Chapter 4

Credit risk

4

4.12 Securitisation

Recognition of significant risk transfer

4.12.1 R

(1) A *firm* must notify the *FCA* that it is relying on the deemed transfer of significant credit risk under article 244(2) of the *EU CRR* (Traditional securitisation) or article 245(2) of the *EU CRR* (Synthetic securitisation), including when this is for the purposes of article 337(5) of the *EU CRR*, no later than one month after the date of the transfer.

(2) The notification in (1) must include sufficient information to allow the *FCA* to assess whether the possible reduction in risk-weighted exposure amounts which would be achieved by the *securitisation* is justified by a commensurate transfer of credit risk to third parties.

Significant risk transfer notifications and permissions

4.12.2 G

An *originator* of *securitisations* is able to use the *securitisation* risk weights (and not calculate *own funds requirements* on the assets underlying its *securitisation*) in either of the following cases:

(1) the *firm* transfers significant credit risk associated with the *securitised exposures* to third parties; or

(2) the *firm* deducts from *common equity tier 1 capital* or applies a 1250% risk weight to all positions it holds in the *securitisation*.

4.12.3 G

The significant risk transfer requirements in articles 244 (Traditional securitisation) or 245 (Synthetic securitisation) of the *EU CRR* provide three options for a *firm* to demonstrate how it transfers significant credit risk for any given transaction:

(1) the *originator* does not retain more than 50% of the risk-weighted exposure amounts of mezzanine *securitisation positions* (as defined in article 242(18) of the *EU CRR*), where these are:

(a) *securitisation positions* to which a risk weight lower than 1250% and higher than 25% applies in accordance with Sub-Sections 2 and 3 of Section 3 of Chapter 5 (Securitisation) of the *EU CRR*; and

(b) subordinated to the senior *securitisation position* and more senior than the first loss tranche;

(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 1250% 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.

Significant risk transfer under options 1 and 2

4.12.4 G IFPRU 4.12.1 R requires a *firm* to notify the *FCA* of each transaction on which it seeks capital relief under the options in IFPRU 4.12.3 G (1) (option 1) and (2) (option 2).

4.12.5 G Where the *FCA* considers that the possible reduction in risk-weighted exposure amounts (RWEA) achieved via the *securitisation* is not justified by a commensurate transfer of credit risk to third parties, significant risk transfer will be considered to not have been achieved. Consequently, a *firm* will not be able to recognise any reduction in RWEA due to the transaction.

Option 3

4.12.6 G For IFPRU 4.12.3 G (3) (option 3), the *FCA* intends to grant permission for an *originator* to make its own assessment of significant risk transfer only where it is satisfied that:

(1) in every relevant case, the reduction in *own funds requirements* achieved would be justified by a commensurate transfer of risk to third parties;

(2) the *firm* has adequate internal risk management policies and methodologies to assess the transfer of risk; and

(3) such transfer of risk to third parties is also recognised for the purposes of the *firm*'s internal risk management and internal capital allocation.

4.12.7 G Where the *FCA* grants permission for multiple transactions, then that permission is expected to cover a defined scope of potential transactions. The permission is expected to enable a *firm* (within certain limits) to carry out these transactions without notifying the *FCA* in each individual instance.

Deduction or 1250% risk weighting

4.12.8 G A *firm* seeking to achieve capital relief by deducting or applying a 1250% risk weight where permitted under articles 244 or 245 of the *EU CRR* does not need to make the notification in IFPRU 4.12.1 R. However, in such cases, a *firm* should consider whether the characteristics of the transaction are such that the *FCA* would reasonably expect prior notice of it.

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Significant risk transfer notifications

4.12.9 G Under IFPRU 4.12.1 G, within one *month* of a *securitisation* transaction closing, a *firm* must notify the *FCA* of the transaction if it has relied on options 1 or 2 to achieve significant risk transfer.

4.12.10 G Notification under IFPRU 4.12.1 G should include sufficient information to enable the *FCA* 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 *FCA* expects this to include the following:

(1) details of the *securitisation positions*, including rating, *exposure* value and RWEA broken down by *securitisation positions* sold and retained;

(2) key transaction documentation and any relevant supporting documents (eg, a summary of the transaction);

(3) details of the governance process for the transaction, including details of any committees involved in approving the transaction;

(4) a copy of the significant risk transfer policy applied to the transaction, including details of the methodology and any models used to assess risk transfer;

(5) a statement of how all relevant risks are incorporated into the significant risk transfer assessment and how the full economic substance of the transaction is taken into consideration;

(6) the significant risk transfer calculation, setting out why the *firm* believes the capital relief proposed is commensurate with the credit risk transferred to third parties;

(7) the *EU CRR* requirements the *firm* is relying on;

(8) copies of investor and internal presentations on the transaction;

(9) the rationale for the transaction;

(10) details of the underlying assets (including asset class, geography, tenor, rating, spread, collateral, *exposure* size);

(11) details of the transaction structure;

(12) description of the risks being retained;

(13) details of the cashflow between parties involved in the transaction;

(14) details of the ratings and pricing of bonds issued in the transaction;

(15) details of any connected parties involved in the transaction;

(16) details of any termination options (for example, call options); and

(17) details of reliance on *ECAIs* in the significant risk transfer assessment.

4.12.11 G The *FCA*'s review will focus on the proportion of credit risk transferred, compared to the proportion by which RWEA are reduced in the transaction. Where the *FCA* judges that the reduction in RWEA is not justified by a commensurate transfer of credit risk to third parties, it will inform the *firm* that significant risk transfer has not been achieved by this transaction. Otherwise, the *FCA* will inform the *firm* that it does not object to the transaction.

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

Significant risk transfer permissions

4.12.13 G A *firm* may apply for permissions under articles 244 (Traditional securitisation) or 245 (Synthetic securitisation) of the *EU CRR* to consider significant risk transfer to have been achieved without needing to rely on options (1) or (2). The scope of such permission maybe defined to cover a number of transactions or an individual transaction.

Multiple transaction permissions

4.12.14 G Where a *firm* applies for such permission, the *FCA* would expect the scope should be defined according to a range of characteristics, including the type of asset class and the structural features of the transaction. The characteristics the *FCA* would expect a *firm* to consider when scoping a permission application include:

(1) asset class (eg, residential mortgages, commercial mortgages, credit card receivables, leasing, loans to corporates or small and medium-sized enterprises (SMEs), consumer loans, trade receivables, *securitisations*, private finance initiative (PFI), insurance, other assets, covered bonds);

(2) further asset class distinction (eg, geography and asset quality); and

(3) structural features (eg, by distinguishing between securitisation and re-securitisation, traditional and synthetic securitisation and non-revolving structures and revolving structures).

4.12.15 G It is likely for it to be more straightforward for the *FCA* to assess relatively narrowly scoped permissions than those covering a wide range of assets and/or with complex structural features.

Areas of review and information to be submitted for permission

4.12.16 G To assess a *firm's* ability to use its own policies and methodologies for assessing significant risk transfer, the *FCA's* permission reviews will focus on:

(1) the *firm*'s understanding of the risk of any potential transactions within permission scope, including for potential underlying assets, *securitisation* structures and other relevant factors that affect the economic substance of risk transfer;

(2) the governance around significant risk transfer assessment (including sign-off procedures) and systems and controls relating to risk-transfer assessment and determination of significant risk transfer;

(3) significant risk transfer calculation policies and methodologies, including any models used;

(4) the *firm*'s historical experience with relevant *securitisation* origination; and

(5) the use of third-party risk assessments (eg, *ECAI* ratings) and the relationship with internal assessments.

4.12.17 G The information the *FCA* expects a *firm* to provide in a permission application includes the following:

(1) details of the *firm*'s governance processes for significant risk transfer, including details of any relevant committees and the seniority and expertise of key persons involved in sign-off;

(2) a copy of the *firm*'s significant risk transfer policy, including details of the significant risk transfer 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);

(3) a statement of how all relevant risks are incorporated in the significant risk transfer calculations and how the full economic substance of transactions is taken into consideration;

(4) details of the *firm*'s systems and controls regarding risk transfer in *securitisations*;

(5) a copy of the *firm*'s capital allocation strategy;

(6) details of any *securitised* assets that have come back on the *firm*'s balance sheet and the reason why; and

(7) details of reliance on *ECAIs* in determining significant risk transfer.

Limits attached to multiple transaction permissions: materiality

4.12.18 G The *FCA* intends to apply two materiality limits to the proportion of risk-weighted exposure amount (RWEA) relief that can be taken under any permission covering multiple transactions:

(1) 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

(2) aggregate limit once the aggregate RWEA reduction taken on all significant risk transfer 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:

   (a) reapply to renew the multiple transaction permission; or

   (b) apply for a new permission covering the specific transactions exceeding the RWEA limit; or

   (c) notify the *FCA* of the transaction, following the significant risk transfer notification procedure (if the transactions would satisfy option 1 or 2).

Limits attached to multiple transaction permissions: duration of permission

4.12.19 G Multiple transaction permissions can be expected to be granted for a period of one year. The *FCA's* review of permission renewal will focus on any changes to the *firm's* significant risk transfer policies and methodologies since the previous review.

Individual transaction permission

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

4.12.21 G The information the *FCA* expects to receive in an individual transaction permission includes that in IFPRU 4.12.10G (2) and IFPRU 4.12.10 G (6) to IFPRU 4.12.10 G (17), as well as that in IFPRU 4.12.17G (1) to (3).

Limits attached to individual transaction permissions

4.12.22 G Depending on the nature of a transaction, the *FCA* may grant an individual permission for the duration of the transaction, or may impose a time limit on the permission. Where a *firm* sought to take capital relief on a transaction beyond the expiry date of the relevant permission, the *firm* would need to renew the permission prior to its expiry date.

4.12.23 G Given that significant risk transfer should be met on a continuing basis, permissions will typically include a requirement to notify the *FCA* of any change in circumstances from those under which the permission was granted (eg, where the amount of credit risk transfer had changed materially). Any reduction in credit risk transfer subsequent to the permission being granted will require the *firm* to take a commensurate reduction in RWEA relief. If a *firm* does not effect a commensurate reduction in the RWEA relief, the *FCA* may revoke the relevant permission.

Regulatory capital calculation methodology and significant risk transfer

4.12.24 G An *originator* 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 Part Three, Title II, Chapter 5 of the *EU CRR* (Securitisation), and any associated reduction in *own funds requirements* must be matched by a commensurate transfer of risk to third parties.

4.12.25 G As part of the notification and permissions process, the *FCA* expects the *firm* to inform it of the methodology it intends to use to calculate *securitisation* capital requirements.

Implicit support and significant risk transfer

4.12.26 G As part of a *firm*'s ongoing consideration of risk transfer, the *FCA* expects it to consider the support it has provided to *securitisation* transactions.

4.12.27 G

(1) 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 *FCA* will take account of this increased expectation in future assessments of commensurate risk transfer to that firm.

(2) The *FCA* 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.

(3) Where a *firm* provides support which it is entitled, but not obliged, to provide under the contractual documentation of the *securitisation*, the *FCA* will consider the following factors in assessing if that support has been appropriately reflected in the assessment of significant risk transfer:

(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 significant risk transfer 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.

(4) If a *firm* fails to comply with article 250(1) of the *EU CRR*, the *FCA* may require it to disclose publicly that it has provided non-contractual support to the transaction.

High-cost credit protection and other significant risk transfer considerations

4.12.28 G Some transactions can transfer little or no economic risk from the protection buyer to the protection seller, but may still result in a reduction in *own funds requirements*. A particular example of a transaction-type of concern involves protection being purchased on a junior tranche and a high premium is paid for that transaction.

4.12.29 G Generally, the amount of premium paid will not materially affect the assessment of whether significant risk transfer has occurred. This is because either:

(1) 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

(2) the payment of premium leads to an immediate incurred cost.

4.12.30 G However, there comes a point at which the premium payable for the protection can reduce significantly the actual 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.

4.12.31 G The *FCA* expects *originators* seeking to apply the *securitisation* risk weights to synthetic *securitisations* to take into account all relevant factors to assess the amount 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 *FCA* expects a *firm* seeking capital relief through synthetic securitisations to incorporate premiums in their assessment of significant risk transfer. In particular, the following transaction features may have a significant impact on the amount of risk transfer:

(1) premium which is guaranteed in all or almost all circumstances, for example, premium which is payable upfront or deferred; or

(2) 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; or

(3) those under which the protection buyer retains the expected loss through higher transaction costs to the counterparty, in the form of premium or otherwise.

4.12.32 G Article 238 of the *EU CRR* (Maturity of credit protection) requires maturity to be assessed in considering significant risk transfer. When considering the effective maturity of synthetic *securitisations*, the *FCA* expects a *firm* to consider whether the transaction contained an option to terminate the protection at the discretion of the protection buyer.

4.12.33 G The *FCA* considers the following to be examples of features which generally indicate a positive incentive to call or, at least, to constitute grounds for discussion with the *FCA* prior to the conclusion of the transaction:

(1) the transaction contains terms, such as payments at maturity or payments upon early termination or significant premiums, which may reduce risk transfer;

(2) 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

(3) 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.

High-level significant risk transfer considerations

4.12.34 G Significant risk transfer is an ongoing requirement. Accordingly, the *FCA* expects *firms* to ensure that any reduction in *own funds requirements* achieved through *securitisation* continues to be matched by a commensurate transfer of risk throughout the life of the transaction. The *FCA* expects *firms* to take a substance over form approach to assessing significant risk transfer. *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 retained risk.

4.12.35 G When risk transfer transactions are structured as a group of linked transactions rather than a single transaction, the *FCA* expects the aggregate effect of linked transactions to comply with the *EU CRR*. The *FCA* 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.

4.12.36 G The *FCA* expects the instruments used to transfer credit risk not to contain provisions which 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 *FCA* expects the *originator's* net cost of protection or the yield payable to investors should not increase as a result.

4.12.37 G To ensure continued appropriateness, the *FCA* expects *firms* to update the opinions of qualified legal counsel, required by the *EU 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.

4.12.38 G The *FCA* 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.

4.12.39 G The *FCA* does not operate a pre-approval process for transactions. The *FCA* expects a *firm* to discuss with its supervisor at any 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 *FCA* 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 *FCA's* stated policy.

4.12.40 G Although this section sets out the *FCA's* expectations regarding *securitisations*, these expectations are also relevant for other similar credit protection arrangements.

4.12.41 G The *FCA* will seek to ensure that the *securitisation* framework is not used to undermine or arbitrage other parts of the prudential framework. For other similar credit protection arrangements (eg, those subject *credit risk mitigation* or *trading book* requirements), the impact of certain features (such as significant premiums or call options) may cast doubt on the extent of risk transferred and the resulting capital assessment. Features which result in inadequate *own funds 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 *ICG* in Pillar 2 add-ons. Credit protection arrangements in general are subject to the same overarching principles as those in the *securitisation* framework.

4.12.42 G Where a *firm* achieves significant risk transfer for a particular transaction, the *FCA* expects it to continue to monitor risks related to the transaction to which it may still be exposed. The *firm* should consider capital planning implications of *securitised* assets returning to its balance sheet. The *EU CRR* requires a *firm* to conduct regular stress testing of its *securitisation* activities and off-balance sheet *exposures*. The stress tests should consider the *firm*-wide impact of stressed market conditions on those activities and *exposures* and the implications for other sources of risk (eg, credit risk, concentration risk, counterparty risk, *market risk*, *liquidity risk* and reputational risk). Stress testing of *securitisation* activities should take into account both existing *securitisations* and pipeline transactions. A *firm* should have procedures in place to assess and respond to the results of that stress testing and these should be taken into account under the *overall Pillar 2 rule*.