BANKING STAKEHOLDER GROUP

Consultation on EBA/CP/2016/01 onDraft Guidelines on implicit support under Article 248(2) of Regulation (EU) No 575/2013

# General Comments and Replies to Questions

BY THE EBA BANKING STAKEHOLDER GROUP

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# Foreword

The EBA Banking Stakeholder Group (BSG) welcomes the opportunity to comment on the Consultation Paper EBA/CP/2016/01.

This response outlines some general comments by the BSG, as well as our detailed answers to some questions indicated in the CP.

# General comments

The BSG welcomes EBA's consultation paper and its initiative to produce a set of clear guidelines that can eliminate uncertainty in the securitisations market, especially legal uncertainty and act as another measure for the revival of the securitisations market in Europe. The revival of the market for securitized debt is also at the heart of the EU commission's proposals for the creation of a European capital markets union. We also cross-refer to BSG's submission of 14 January 2015 on EBA/DP/2014/02 ON "SIMPLE, STANDARD AND TRANSPARENT SECURITISATIONS" and the more general remarks made there in favour of reviving the market for securitisations in the EU without losing sight of risks.

The treatment of implicit support for securitisation as spelled out in the CRR is motivated by the fact that a number of CDS contracts and liquidity lines and other forms of overt or hidden support to SPVs were triggered during the last crisis generating enormous calls on the liquidity of originator or sponsor institutions. In particular, financial institutions which were thought to have diversified their risk through Off Balance Sheet Entities (OBSEs) and

credit derivatives had not realized how much risk they had in fact retained through the provision of guarantees or backstop liquidity lines.[1] Worse, the slice (tranche) they had retained in those entities referred to the riskiest and least worthy part of OBSEs' assets. Subsequently, several banks felt compelled to increase such exposures when the value of those entities collapsed in order to protect their good reputation with investors. So they chose to purchase assets from, or extend credit to, OBSEs that were set up or managed by them, restocking their balance sheets with low quality ('toxic') assets.[2]

But today most of the aforementioned forms of support would qualify as contractual support and count towards the true risk transfer criteria for the calculation of the originator's capital requirements. Accordingly it is very plausible that EBA's consultation focuses on forms of implicit support aiming to shore up the solvency or the liquidity of SPVs and targets the elimination of risks arising from such arrangements in accordance with the requisite CRR provisions (Aº 248).

We support the general approach followed in the guidelines, which focus on clarifying the requirements set out in Aº 248 in order to achieve

[1] IMF, Global Financial Stability Report, Containing Systemic Risks and Restoring Financial Soundness, April 2008, pp. 70–2.

[2] Ibid. See also Emilios Avgouleas, *Governance of Global Financial Markets: The Law, the Economics, the Politics* (Cambridge University Press, 2012), Ch. 2.

greater consistency in its application. This is not an easy task and the first step is to define what is implicit versus explicit support. To distinguish between obvious forms of explicit support such as, for instance, CDS contracts or granting second loss guarantees over a specific portfolio, EBA offers examples of what constitutes implicit support:

> Examples of implicit support include the purchase of deteriorating credit risk exposures from the underlying pool, improving the quality of credit enhancements, such as through the addition of higher quality risk exposures, the sale of discounted credit risk exposures into the pool of securitised credit risk exposures, the purchase of underlying exposures at above market price, ad hoc credit enhancements provided to one or more tranches or an increase in the first loss position according to the deterioration of the underlying exposures.

This is a broad definition and EBA plausibly does not suggest banning these forms of support from the outset but rather suggests a number of criteria to assess such transactions. So its CP states:

[A] transaction is not structured to provide support if it satisfies the following conditions:

1. in the case of a transaction carried out by a sponsor institution, the transaction is executed (i) at arm's length conditions or (ii) on conditions which are more favourable to the sponsor institution than arm's length conditions;
2. in the case of a transaction carried out by an originator institution which has transferred significant credit risk associated with the underlying exposures of the securitisation in accordance with Article 243 or 244 of Regulation (EU) No 575/2013:
    i. the transaction is executed (1) at arm's length conditions or (2) on conditions which are more favourable to the originator institution than arm's length conditions; and
    ii. the securitisation continues to meet the conditions for significant risk transfer as set out in Article 243 or, as the case may be, 244 of Regulation (EU) No 575/2013 and in accordance with these guidelines and with guidelines EBA/GL/2014/05 on significant risk transfer.

To this effect EBA introduces the arm's length test for transactions that could amount to implicit support, which is described to mean:

(a) Transactions executed in normal commercial terms while the parties have no relationship to each other (including, but not limited to, any special duty or obligation and any possibility to control or influence each other), and

(b) each party acted independently, entered into the transaction of its own volition, acted in its own interests and did not take into account any extraneous considerations which are not directly connected with the transaction in question (including, but not limited to, any reputational risk which might arise in respect of the originator institution or the sponsor institution should it not proceed with the transaction).

Naturally, EBA needs a comprehensive definition but at the same time this may not be so strict as to hamper the functions of securitisation markets. For instance, while it looks like an implicit support or subsidy replacing existing exposures with new ones of higher quality, this could be a reasonable part of the implied duties of originators or sponsors towards SPV investors. Replacement or topping up activity works in favour of having a liquid securitisation market it does no harm to investor interests and sponsoring or originating institutions will only do so in the full knowledge that such actions have an adverse impact on the bank's capital position and overall risk profile. In the absence of a contractual obligation to do so, in which case support wouldn't be implicit, such activity will happen very rarely and when another risk would be higher (e.g., any reputation risk esp. for the sponsor). So a blanket prohibition seems to us misguided and disproportionate. As noted in our 2015 response:

> Often ABCP are "fully supported": meaning that any losses of the investors are borne by the provider of the liquidity facility. therefore With the revision of the Basel framework for securitisations, there is a risk that ABCP will be negatively affected. In this context two roles have to be distinguished that banks can play in an ABCP multi-seller conduit: investor and sponsor banks. The fact that ABCP are not issued without a sponsor bank that

> provides the liquidity facility the treatment of these facilities in the capital requirements regime is of utmost importance. There is a risk that capital requirements for liquidity banks multiply 3-4 times compared to the current framework and exceed the risk weights for senior unsecured corporate loans. Thus ABCP financing will become unattractive for sponsors and very expensive for sellers. Therefore, ABCP as well as the corresponding liquidity facilities should be recognised as "simple standard and transparent securitisations" and should be rewarded with a special regulatory treatment.

To this effect while EBA's guidance that all transactions should be either at arms' length or at market terms is accurate but the value of continuous supervision should not be discounted. An institution granting new higher quality credits on the top of existing collateralized assets or in replacement of lower grade assets will increase banks' capital requirements for contingent liabilities and leverage ratios ad hoc. Banks rebalance their portfolios on a daily basis. It is not clear why a replacement or topping up activity to stave off reputation risk, in the absence of a pre-commitment do so, is an unmanageable development under the bank's capital framework and such ad hoc support should render the securitisation in question as a non true risk transfer transaction.

## Replies to Questions

### Question 1: Do you have any general comments on the draft guidelines on implicit support under Article 248(2) of Regulation (EU) No 575/2013?

See general remarks above

### Question 2: Do you have any comments on the proposed definition of transactions not structured to provide support?

The consultation paper states that a transaction carried out by an originator institution is not structured to provide support if it is executed at arm's length conditions (or are more favourable to the originator) and the securitisation continues to meet the conditions for significant risk transfer (SRT). Failing to meet this latter condition should not automatically lead to the conclusion that implicit support has been provided. The loss of SRT might result from a the a risk management decision of the bank, that decides to increase its exposure on a securitisation transaction, having nothing to do with supporting investors. If the transaction is executed at arm's length (or better) conditions, it should be outside the scope of the implicit support rules and do not be considered for the sanctions contemplated in Aº 98(3) of Directive 2013/36/EU. We consider the inclusion of replacement or topping up activity that happens ad hoc and not on the basis of a pre-commitment and is based on a need to stave off reputation risk as one that should not negate the true risk transfer qualification. The institution engaging in this ad hoc activity will be regulated on a continuous basis. Banks and financial institutions rebalance their asset and liability portfolios on a daily basis and are subject to re-adjusted capital and liquidity requirements accordingly. We do not see how such activity if it is not based on a pre-commitment negates the true risk transfer qualification of a requisite transaction.

Question 3: Do you have any comments on the proposed definition of arm's length conditions?

Why consider this part of the definition:

"did not take into account any extraneous considerations which are not directly connected with the transaction in question"

as one that is capable to harm the liquidity of securitisation markets

Question 4: Do you have any comments on the proposed guidance regarding the factors contemplated in points (a)-(e) of Article 248(1) of Regulation (EU) No 575/2013?

Question 5: Is the arm's length condition in paragraph 10.a of the draft guidelines sufficient to test in all cases whether a sponsor provides support? If not, what would be an appropriate requirement? Please provide examples.

Question 6: Should transactions undertaken by a third party other than the sponsor institution or originator institution be subject to the same assessment with regard to the provision of implicit support as transactions undertaken by the sponsor institution or by the originator institution or should they be subject to different assessment standards (and, if so, which standards)?

The arm's length test should sufficient in such cases.

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Submitted on behalf of the EBA Banking Stakeholder Group