

EBA Consultation Paper
on
Draft Regulatory Technical Standards
on
the concept of Gain on Sale associated with
future margin income in a securitisation
context
(EBA/CP/2012/07)

London, 12.06.2012

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I. Responding to this Consultation

EBA invites comments on all proposals put forward in this paper, and in particular on the specific questions summarised in V.b.

Comments are most helpful if they:

- indicate the specific point or question to which the comment relates;
- contain a clear rationale;
- provide evidence to support the views expressed/ rationale proposed; and
- describe any alternative regulatory choices the EBA should consider.

Please send your comments to the EBA by email to EBA-CP-2012-7@eba.europa.eu by 12.08.2012, indicating the reference 'EBA/CP/2012/07'. Please note that comments submitted after the deadline, or sent to another e-mail address will not be processed.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please indicate clearly and prominently in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an e-mail message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.eba.europa.eu under the heading 'Legal Notice'.

II. Executive Summary

The CRR/CRD IV proposals¹ (the draft so-called Capital Requirements Regulation - henceforth 'CRR'- and the draft so-called Capital Requirements Directive - henceforth 'CRD') set out prudential requirements which are expected to be applicable as of 1 January 2013.

In a number of Articles, the CRR contains specific mandates for the EBA to develop draft regulatory technical standards (henceforth 'RTS') related to the own funds of institutions covered by the CRR. One of these articles contains a mandate to the EBA to develop RTS on the concept of gain on sale associated with future margin income in the context of securitisations.

These RTS will be part of the single rulebook enhancing regulatory harmonisation in Europe with the particular aim of strengthening the quality of capital.

Please note that the EBA has developed the present draft RTS based on the European Commission's legislative proposals for the CRR/CRD IV. It has also taken into account major changes subsequently proposed by the compromise texts produced by the Council of the EU and the European Parliament, during the co-decision process.

Following the end of the consultation period, and to the extent that the final text of the CRR changes before the adoption of the RTS, the EBA will adapt the draft RTS accordingly to reflect any developments. The EBA may also introduce in its draft RTS other changes needed to reflect comments received either internally or in response to this consultation paper.

Main features of this RTS

This Consultation Paper puts forward a draft RTS related to Article 29.2 of the CRR related to prudential filters in the own funds (securitised assets). In particular it requires the EBA to further specify the concept of a gain on sale referred to in Article 29.1(a). The EBA must submit the draft RTS to the Commission by 1 January 2013.

All RTS related to own funds requirements are intended to be put forward as one integrated draft Regulation, as already announced in the EBA Consultation Paper

¹ Proposal for a Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (CRD), and Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms'. These European Commission proposals were published on 20th July 2011.

on RTS for own Funds², published in April 2012. The rationale for this approach is to support the completion of the EU single rulebook for institutions in the area of own funds. It is therefore useful to group these regulations together in one legal act to facilitate a comprehensive view, improve understanding and provide compact access by legal or natural persons subject to the obligations laid down herein. With that in mind, the draft RTS text proposed in the present document is an addition to the draft RTS text proposed in the above-mentioned CP and needs to be read in conjunction with it (art. 9 for the gain on sale RTS under Section 2- Prudential filters).

Article 29 CRR states that:

'1. An institution shall exclude from any element of own funds any increase in its equity under the applicable accounting standard that results from securitised assets, including the following:

- a) such an increase associated with the future margin income that results in a gain on sale for the institution;*
- b) Where the institution is the originator of a securitisation, net gains that arise from the capitalisation of future income from the securitised assets that provide credit enhancement to positions in the securitisation.*

2. EBA shall develop draft regulatory technical standards to specify further the concept of a gain on sale referred to in point (a) of paragraph 1.

EBA shall submit those draft regulatory technical standards to the Commission by 1 January 2013.

Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with the procedure laid down in Articles 10 to 14 of Regulation (EU) No 1093/2010.'

² EBA Consultation Paper on Draft Regulatory Technical Standards on Own Funds – Part one (EBA/CP/2012/02): <http://www.eba.europa.eu/Publications/Consultation-Papers/All-consultations/2012/EBA-CP-2012-02.aspx>.

III. Background and rationale

Draft RTS on the concept of gain on sale associated with future margin income in a securitisation context

The so-called Omnibus Directive³ amended the directives that are collectively known as Capital Requirements Directive (CRD)⁴ in a number of ways, one of which was by establishing areas where the EBA is mandated to develop draft technical standards.

On July 20th 2011, the European Commission (EC) issued its legislative proposals on a revision of the CRD which seeks primarily to apply the Basel III⁵ agreement in the EU. These proposals have recast the contents of the CRD into a revised CRD and a new CRR - which are commonly referred to as the CRR/CRD IV proposals. These are currently being debated by the EU legislators (the Council and the European Parliament) in the framework of the co-decision procedure.

In anticipation of the finalisation of the legislative texts for the CRR/CRD IV, the EBA has developed this draft RTS in accordance with the mandate contained in article 29.2 of the CRR as it features in the EC's proposals.

The EBA may need to adapt the draft RTS according to the final version of the CRR/CRDIV text before submitting it to the European Commission for adoption. The EBA may also introduce in its draft RTS other changes needed to reflect comments received either internally or in response to this consultation paper where they are considered appropriate.

3 Directive 2010/78/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 98/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC, 2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC and 2009/65/EC in respect of the powers of the European Supervisory Authorities: the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority.

4 Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions.

5 Basel III: A global regulatory framework for more resilient banks and banking systems and Basel III: International framework for liquidity, risk measurement, standards and monitoring. Basel Committee on Banking Supervision, December 2010.

The nature of RTS under EU law

Draft RTS are produced in accordance with Article 10 of EBA regulation⁶. According to Article 10(4) of EBA regulation, they shall be adopted by means of regulations or decisions.

According to EU law, EU regulations are binding in their entirety and directly applicable in all Member States. This means that, on the date of their entry into force, they become part of the national law of the Member States and that their implementation into national law is not only unnecessary but also prohibited by EU law, except in so far as this is expressly required by them.

Shaping these rules in the form of a Regulation would ensure a level-playing field by preventing diverging national requirements and would ease the cross-border provision of services since each time an institution expands its activities into any another Member State it will be subject to the same and well known set of rules.

Background on this draft RTS

Basel II⁷ and Basel III, Directive 2006/48 and the proposed CRR establish as a general principle that institutions shall exclude, from their own funds, increases in equity resulting from the sale of the assets being transferred in a securitisation transaction.

In particular, Basel III (paragraph 74) relates to the gain on sale on securitisation transactions and states:

"Derecognise in the calculation of Common Equity Tier 1 any increase in equity capital resulting from a securitisation transaction, such as that associated with expected future margin income (FMI) resulting in a gain-on-sale."

The CRR, Article 29 (in the prudential filters section), in its current version, states:

"An institution shall exclude from any element of own funds any increase in its equity under the applicable accounting standard that results from securitised assets, including the following: (a) such an increase associated with future margin income that results in a gain on sale for the institution; (b) where the institution is the originator of a securitisation, net gains that arise from the capitalisation of future income from the securitised assets that provide credit enhancement to positions in the securitisation."

⁶ Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC.

⁷ International Convergence of Capital Measurement and Capital Standards. Basel Committee on Banking Supervision, June 2004 and further revisions.

Directive 2006/48 does not mention in article 57 the term "gain on sale", but states:

"In the case of a credit institution which is the originator of a securitization, net gains arising from the capitalization of future income from the securitized assets and providing credit enhancement to positions in the securitization shall be excluded from the item specified in point (b)"

Moreover CDR 2006/48 requires, in Annex XII, the disclosure of the bank's accounting policies for the recognition of gain on sales (Pillar III).

Therefore, the exclusion (from the corresponding element of own funds) of increases associated with future margin income is not a new requirement in the regulation.

As required by Art 29.2, this draft RTS further specifies the concept in order to harmonise interpretation by institutions of Article 29.1(a) of the CRR.

Concept of gain on sale in accounting and in the prudential framework

In the International Accounting Standard Board ("IASB") language, the "gain or loss from derecognition" is related to transfers of financial assets⁸. The International Financial Reporting Standard (IFRS) provides rules for derecognition of an asset (or assets) and for when a gain or loss on sale is considered to have occurred.

When transposing the accounting framework into the prudential framework and the solvency requirements, the following scenarios are possible:

a) No derecognition of the financial assets

When according to IFRS there is no derecognition of the financial assets, the issue of "gain on sale" does not arise. In these circumstances, it is expected that the originator will not recognise a gain on sale. However, the entity will continue to recognise income and expenses for the assets and the newly recognised liabilities. For instance, an entity could sell loans and guarantee risk to compensate the transferee for any loss on the loans. The entity could sell the loans for a higher amount than the carrying amount (if they are measured at amortised cost). In this scenario, the entity will recognise an income in future periods as the liability accrues interest until the loans are fully amortised. Therefore, there would be no gain on sale but on-going net gains as part of the transaction.

b) Derecognition or continuing involvement

⁸ Derecognition is the removal of a previously recognised financial asset or financial liability from an entity's balance sheet (IAS 39, par. 9).

If there is derecognition or continuing involvement, then a gain on sale could be booked, i.e. acknowledged, when the assets are derecognised from the balance sheet.

As a result of the above, the gain on sale resulting from future margin income in the context of a securitisation transaction in the prudential framework can be derived following the determination of the gain on sale according to the relevant accounting framework.

Future margin income and future excess spread

In this context, 'future margin income' shall refer to the expectation, based on the terms of the securitisation transaction, to receive the total or part of the future 'excess spread' as defined in Article 237 in the CRR.

If the gain on sale arising from the 'future margin income' has been excluded from own funds, the corresponding asset should be excluded from the application of capital requirements.

IV. Draft regulatory technical standard on the concept of gain on sale associated with future margin income in a securitisation context

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COMMISSION DELEGATED REGULATION (EU) No .../..

Supplementing Regulation xx/XX/EU of the European Parliament and of the Council [CRR number] with regard to regulatory technical standards for the concept of gain on sale in Article 29.1(a)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to [Regulation (..) No xx/xxxx] of the European Parliament and of the Council of dd mmmm yyyy on⁹ [CRR number], and in particular Article 29(2), thereof

Whereas:

....

(e) There is a need to define and align the treatment of the concept of gain on sale associated with a future margin income in the context of securitisation, with international practices (i.e. of the Basel Committee on Banking Supervision) and ensure that no revocable gain on sale is included among the own funds of an institution, given the lack of its permanence.

....

Section 2

Prudential Filters

The concept of gain on sale under Article 29(1)(a) of the CRR

(Legal basis: Article 29(2) of the CRR)

Article 9

1. The concept of gain on sale referred to in point (a) of paragraph 1 of Article 29 CRR shall mean any increase (or part of the increase) in equity under the applicable accounting standard arising from future margin income in the context of a securitisation transaction.
2. In this context, ‘future margin income’ shall refer to the expectation, based on the terms of the securitisation transaction, to receive the total or part of the future ‘excess spread’ as defined in Article 237 CRR.
3. As a result of the above, the gain on sale resulting from future margin income in the context of a securitisation transaction shall be derived by the institutions according to the following three-step approach:

¹³ Directive 2006/48 does not mention in article 57 the term “gain on sale”, but it requires, in Annex XII, the disclosure of the bank’s accounting policies for the recognition of gain on sales (Pillar III).

- (a) Firstly, by determining the gain on sale according to the relevant accounting framework, on the condition that the securitised assets are derecognised (or partly derecognised) or that there is continuing involvement in them, in accordance with the relevant accounting framework.
- (b) Secondly, by assessing the amount of the recorded gain on sale as the difference between the net value of the assets received (including any new asset obtained less any other asset given or any new liability assumed) and the carrying amount of the securitised assets (or of the part derecognised), as defined in the relevant accounting framework.
- (c) Finally, by identifying the part of the recorded gain on sale which is associated to the expected future margin income.

Text for consultation purposes:

Q1. In your view does future margin income being correspond to future excess spread defined in Article 237 of in the draft CRR as 'finance charge collections and other fee income received in respect of the securitised exposures net of costs and expenses'?

Do you consider alternative definitions for future margin income as more appropriate?

Please provide the reasoning behind your responses to the above questions and details of the alternative(s) you would propose.

Q2. In your view does Article 9 above capture and further specify the concept of gain of sale? Do you agree that all relevant concepts have been included? Are there any irrelevant concepts included?

Please provide the reasoning behind your responses to the above and details of alternative(s) you would propose.

V. Accompanying documents

a. Draft Cost- Benefit Analysis / Impact Assessment

Introduction

According to CRR proposals, the EBA shall develop draft regulatory technical standards with regard to the concept of gain on sale associated with future margin income in a securitisation context of the Article 29.2b of the CRR, and shall submit those draft regulatory technical standards to the Commission by 1 January 2013.

Procedural issues and consultation process

The EBA reviewed Directive 2006/48¹⁰ and the CRR to establish if there was any change in the treatment of gain on sale associated with future margin income in a securitisation context and conducted a benchmark exercise between the concept of gain on sale in the accounting and the prudential framework.

The EBA also held a roundtable meeting with industry experts whose input has been taken into account in the drafts RTS and impact assessment.

Problem definition

Basel II¹¹ and Basel III and Directive 2006/48 establish as a general principle that institutions shall exclude, from their own funds, increases in equity resulting from the sale of the assets being transferred in a securitisation transaction.

Therefore, the exclusion (from the corresponding element of own funds) of increases associated with future margin income for an institution is not a new requirement in the CRR.

Reasons for public intervention are usually market and/or regulatory failures. However, in rare instances, for technical standards there may also be procedural or implementing issues that are not market/regulatory failures¹².

Objectives of the technical standards

The objective of this Technical Standard is to achieve a common understanding on the concept of gain on sale for future margin income across Europe and to reduce risk of misinterpretation by institutions of Article 29.1(a) of the CRR as required by Art 29.2(b).

Directive 2006/48 does not mention in article 57 the term "gain on sale", but it requires, in Annex XII, the disclosure of the bank's accounting policies for the recognition of gain on sales (Pillar III).

11 International Convergence of Capital Measurement and Capital Standards. Basel Committee on Banking Supervision, June 2004 and further revisions.

12 Examples could be when EBA is required to provide specific definitions or discussing the timing of implementation of a directive.

Policy options

Instead of using a Technical Standard to clarify the concept of gain on sale for future margin income for securitised assets, Article 29 in the CRR could be re-drafted in such a way to clarify the concept.

The likely economic impacts¹³

The exclusion (from the corresponding element of own funds) of increases associated with future margin income that result in a gain on sale for an institution is not a new requirement in the CRR. Directive 2006/48 establish as a general principle that institutions shall exclude, from their own funds, increases in equity resulting from the sale of the assets being transferred in a securitisation transaction.

The impact and costs and benefits related to this draft RTS are unlikely to be of any significance.

13 The EC IA guidelines refer to social and environmental impacts as well. However considerations of these impacts are unlikely to be relevant for EBA technical standards. The potential exceptions being social impacts on employment, standards and rights related to job quality and impacts on (financial) crime.

b. Overview of questions for Consultation

Q1. In your view does future margin income being correspond to future excess spread defined in Article 237 of in the draft CRR as 'finance charge collections and other fee income received in respect of the securitised exposures net of costs and expenses'? Do you consider alternative definitions for future margin income as more appropriate? Please provide the reasoning behind your responses to the above questions and details of the alternative(s) you would propose

Q2. In your view does Article 9 above capture and further specify the concept of gain of sale? Do you agree that all relevant concepts have been included? Are there any irrelevant concepts included? Please provide the reasoning behind your responses to the above and details of alternative(s) you would propose.

Q3.In your view does Article 9 result in any incremental costs or benefits?