Association for Financial Markets in Europe

Consultation response

EBA consultation on technical standards to help originator institutions determine the exposure value of synthetic excess spread in securitisations

13 October 2022

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the EBA's consultation on draft regulatory technical standards specifying the determination by originator institutions of the exposure value of synthetic excess spread published on 9 August 2022.

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

General Observations

AFME members strongly disagree with the proposed approach to the calculation of the exposure value of synthetic excess spread ("**SES**") set out in in the Draft RTS contained in the EBA Consultation Paper dated 9 August 2022 (EBA/CP/2022/11) (the "**Consultation Paper**"). If implemented in their present form, the Draft RTS will render the use of SES uneconomic in virtually all synthetic securitisations. This includes securitisations sponsored by the European Investment Fund which have been fundamental to supporting bank lending to the real economy across the EU For many years.

Members are also very disappointed that, yet again, it appears that a regulatory approach is being proposed which is overly conservative and fails to recognise the observed reality of the performance of the synthetic securitisation market across the EU. With the one exception of the introduction of the STS framework for on-balance sheet securitisation in 2021 (which was itself the result of many years of concerted lobbying by the industry), every single "reform" of the regulations makes synthetic securitisation more difficult and less useful as a tool for managing the credit risk associated with banks' exposures so that they can continue providing credit to the real economy. Examples include the grossly overly-conservative risk-weights applied to the senior tranches of securitisations under the revised Securitisation Framework introduced in 2019 (based, as they were, on the experience of securitisations of US sub-prime mortgages during the financial crisis in 2008–09, an experience which bore no resemblance to the performance of securitisation in the EU), the overly-conservative calibration of the "p factor" and the simplistic and poorly-conceived tests for commensurate risk transfer set out in the EBA's SRT Report published in November 2020 (EBA/Rep/2020/32) (the "**SRT Report**"). Instead of recognising that synthetic securitisation has been a prudent and very useful tool used by banks to manage their credit risk, regulators seem fixated on making that process more difficult.

All of this has occurred during a period where regulators have, despite several challenges from the industry, failed to provide *any* evidence for the supposed increased prudential/macro risk associated with synthetic securitisation. Despite the ongoing excellent performance of synthetic securitisation in the EU, including during significant stress events such as the Covid-19 pandemic, balance sheet

synthetic securitisation in the EU continues to be viewed with a stigma associated with the US arbitrage synthetic securitisation market from pre-2008, despite there being simply no evidence that EU banks are engaging in such activity or have any intention of doing so. Indeed, the excesses of that market, as typified in films such as "The Big Short", sit entirely outside the scope of SRT synthetic securitisation for the simple reason that a bank cannot execute a SRT transaction in respect of exposures which it does not actually have on its balance sheet. Attempting to do so would achieve zero regulatory capital relief as no risk would have been transferred. Indeed, as such arbitrage synthetic securitisations would never be recognised as SRT transactions, formulating rules in the SRT framework in ways designed to address the evils of such transactions is entirely redundant, and only serves to limit banks' ability to execute prudent balance sheet synthetic securitisations. Further, key regulatory reforms since the financial crisis of 2008–09, most notably the risk retention requirements in Article 6 of the EU Securitisation Regulation (Regulation (EU) 2017/2402), the "**EUSR**") and the ban on resecuritisation in Article 8 of the EUSR, mean that such transactions are simply not permitted in the EU market in any case.

The reality is that, despite the frequent comments made in discussion papers (see, for example, paragraph 4 of the Consultation Paper, Recital (7) to the Draft RTS, and Paragraphs (A), (B) and (C) of Section 5.1 to the Consultation Paper), and even in the recitals to EU regulations (see, for example, Recital (11) to Regulation (EU) 2021/558) about the risk of banks using synthetic securitisation to engage in regulatory arbitrage, there is simply *no* evidence that banks have in fact been using synthetic securitisation for this purpose. On the contrary, *all* SRT transactions executed by EU banks in recent years have been done for prudent risk management purposes. There comes a point where the regulatory framework needs to stop chasing shadows in this regard, and the EBA needs to exercise its mandate under Article 248(4) of the CRR against this backdrop, with the objective of enacting sensible and prudent capital rules, and not simply by applying a simplistic (and, in AFME members' view, flawed) reading of the text of Article 248(1)(e) of the CRR without taking into account how that article fits into the broader prudential framework of the CRR or the impact that such a simplistic interpretation will have on the what is currently a well-functioning market. Regulatory reform should be motivated by a desire to *improve* real deficiencies in the existing framework, not addressing unfounded concerns.

In the specific case of SES, the concern around the potential for regulatory arbitrage is also somewhat surprising given that the by far the largest section of the market using SES is synthetic securitisations where the protection provider is the European Investment Fund, deploying funds made available for that very purpose by the European Commission or EU Member States. Indeed since 2015, EIF has closed around 50 synthetic securitisations referencing in aggregate more than EUR 62 billion of underlying exposures. Of these, 42 transactions, with a combined portfolio value in excess of EUR 48 value, made use of synthetic excess spread, and virtually all of these transactions would not be viable if the originator is required to hold capital an exposure value for that SES calculated in the manner prescribed in the Draft RTS.[1] No useful social, economic or regulatory purpose will be achieved by cutting off the ability of the EIF to continue providing this important support to banks across the EU.

The relationship between credit risk management and capital relief

Banks' ability to manage credit risk is inextricably linked to achieving a commensurate reduction in the regulatory capital charge relating to that credit risk. In many cases that is what makes it economically viable for the bank to pay the associated costs to hedge the credit risk. The EBA's own analysis in Section 5 of the Consultation Paper shows that its proposed approaches to calculating the exposure

[1] This information is based on discussions between AFME and EIF.

value of SES will result in a reduction of approximately 30% in the amount of capital relief generated by a synthetic securitisation for the sample of 15 transactions analysed by the EBA (see Table 2 in Section 5.1(D) of the Consultation Paper). It is very surprising, and in AFME members' view, inappropriate, that the EBA offers up this analysis without any apparent acknowledgement in its impact assessment that that level of reduction in the capital relief generated by the securitisation will render the transaction completely uneconomic. The level of capital relief generated by a securitisation cannot be considered in isolation. It needs to be balanced against the cost of achieving that relief, as is effectively acknowledged by the EBA in Section 3.2.6 and Recommendation 6 of the SRT Report (albeit that, as the EBA is aware, AFME members have concerns about Recommendation 6). It is therefore obvious that where the amount of capital relief is reduced so significantly, given that there would be no corresponding reduction in the cost of the protection, the transaction will become uneconomic. Thus, *on the basis of the EBA's own analysis* of the level of reduction in regulatory capital relief, the effect of these proposals will be to prevent the use of SES in SRT synthetic securitisations, including those transactions where EIF acts as the protection provider, even if this is not actually acknowledged by the EBA in the Consultation Paper. AFME members do not consider that this is a valid implementation of Article 248(1)(e). If the legislators had intended to ban the use of SES, that could (and, for reasons of regulatory transparency, *should*) have been achieved through a simple provision to that effect, rather than achieving the same outcome through the back door in the calculation of the exposure value of SES. See our response to Question 11, below, for further elaboration on why AFME members do not consider that this outcome is consistent with the text of Article 248(1)(e).

As a result, by reducing the regulatory capital relief which can be achieved through synthetic securitisation, the regulatory framework makes it more and more difficult for banks to engage in prudent credit risk management.

Balance sheet synthetic securitisation is not intrinsically risky

Before turning to the specifics of the appropriate regulatory treatment of SES, is necessary to bear the following points in mind.

- First, the rules for significant risk transfer are inherently conservative. Because of the non-neutrality principle in the Securitisation Framework in Part Three, Title II, Chapter 5 of the CRR, the sum of the risk-weighted amounts for each tranche in the securitisation will always be more than the aggregate risk-weighted amounts for the securitised exposures prior to the execution of the securitisation. This means that, once the collateral provided by investors for the protected tranche(s) under a synthetic securitisation is taken into account, the originator will actually have *more* assets available to absorb losses on the securitised exposures (ie, a combination of its own funds requirement for the retained positions and the collateral provided by investors) than it had available prior to the securitisation, as illustrated in the example below.[2] Thus, regardless of the treatment of SES, or indeed whether the amount of risk transfer satisfies the commensurate risk transfer tests set out in the SRT Report, the originator will always be in a stronger position following the execution of the securitisation that it was beforehand.

[2] While this will not be the case for an unfunded synthetic securitisation, that is taken into account by the risk-weighting applied to the protection provided by the investors.

Pre-Securitisation	
Portfolio Notional Amount	EUR 1,000,000,000
Average risk-weight	100%
Portfolio RWA	EUR 1,000,000,000
Own funds requirement	8% x Portfolio RWA = EUR 80,000,000

Post-Securitisation			
Tranches	*Notional Amount*	*Tranche RWA*	*Own funds requirement*
Senior Tranche (retained)	EUR 920,000,000	EUR 138,000,000 (assuming 15% risk-weight floor)	EUR 11,040,000
Mezzanine Tranche (placed, cash collateralised)	EUR 70,000,000	0%	EUR 0
Junior Tranche (retained)	EUR 10,000,000	EUR 125,000,000	EUR 10,000,000

The total funds available to cover losses post-securitisation is therefore the sum of the EUR 21,040,000 own funds requirement and the EUR 70,000,000 cash collateral provided by investors, making a total of EUR 91,040,000, as compared with the EUR 80,000,000 which was available prior to the securitisation.

- Secondly, all SRT transactions are required to go through the SRT assessment process with their supervisor, and supervisors retain discretion under Article 245(2) of the CRR to disallow the recognition of SRT for any transaction where they feel the reduction in risk-weighted amounts is not justified by a commensurate transfer of risk to third parties, as well as the power under Articles 258(2) and 254(4) to disallow the use of the SEC-IRBA or SEC-SA methodologies respectively where they feel that they do not adequately reflect the risks associated with the securitised exposures. Together, these mechanisms provide the bank's supervisor with sufficient discretion to prevent the recognition of SRT for any transaction which it felt *was* being executed to exploit a regulatory arbitrage.

- Thirdly, as illustrated so clearly in the EBA's Report on the STS Framework for Synthetic Securitisation in May 2020 (EBA/OP/2020/07), the performance of synthetic securitisations has been no worse than, and in many cases has been better than, the performance of traditional securitisations. With the exception of a small number of synthetic CMBS securitisations executed pre-2008 (and which are very different from the types of synthetic securitisations executed by EU banks since then), there have been *no* examples of losses having been allocated to the retained senior tranches of such securitisations.

- Fourthly, as the EBA has itself noted in both the SRT Report and the Consultation Paper, it is very difficult to prescribe formulaic tests that are sufficiently nuanced to reflect the wide range of portfolios which are the subject of synthetic securitisations, as well as the broader context in which the originator is executing the transaction. If all of the EBA's proposals in this regard were implemented, the originator will need to apply multiple models to determine (i) the mechanistic tests under Article 245(2) of the CRR, (ii) the commensurate risk transfer tests set out in the SRT Report, (iii) the effect of pro-rata amortisation under several different scenarios, (iv) the cost of protection under several different scenarios, (v) the equivalent exposure value of excess spread ("**EEVES**") as set out in the SRT Report, (vi) the WAM for each securitised tranche under Article 257 of the CRR, and now (vii) the exposure value of SES for the purposes of Article 248(1)(e) of the CRR. AFME members agree that proper modelling of the performance of a transaction is an important part of the SRT assessment process, and indeed they always undertake those

calculations themselves, using appropriate parameters for the specifics of the portfolio to be securitised, as part of determining the economic viability of the transaction. However, each time the regulations are modified to prescribe mathematical calculations which either apply as a "pass/fail" test or effectively to increase the amount of capital required to be held by the originator in respect of the securitisation, they make it more and more likely that one of these requirements will render a transaction unviable, even though viewed in totality the transaction is prudent and sensible. This is particularly the case given that every one of these models is different, and each applies a highly conservative approach in its own way.

- Fifthly, the flip side of the previous point is that overly prescriptive tests can actually *incentivise* regulatory arbitrage just as much as prevent it. Please see our response to Question 6 below for discussion of how that is the case with the Draft RTS for SES.

Basic principles to govern the treatment of synthetic excess spread

Turning then specifically SES, the method for determining the exposure value of SES must take into account the following points:

- First, the regulatory framework for securitisation generally adopts a consistent approach to traditional and synthetic securitisations. This in itself is motivated by a desire to avoid creating regulatory arbitrage between the two different types of securitisation. There is no reason at all why SES should be treated as an exception to this general principle of equal treatment, and AFME members strongly disagree with the suggestions to the contrary in paragraph 8(ii) of the Consultation Paper, for reasons which are set out in our response to Question 11, below.

- Secondly, the treatment of SES needs to be considered against the backdrop of the overall capital framework set out in the CRR, which is based on a one-year time horizon. That is, it is losses for the current year, and the amount by which one-year expected losses exceed specific credit risk adjustments that are deducted from capital under Article 36(1) of the CRR. Thus, requiring an originator to hold capital against the *lifetime* expected losses (capped at the contractual amount of SES) is inconsistent with the principles on which the capital framework is based.

- Thirdly, SES needs to be understood in the context of the overall economics of the securitised portfolio for the bank. Banks are not in the business of making losses, and viewed at a portfolio level, at the time of origination it will always be the case that the yield on the portfolio is sufficient to cover *both* the cost of funding the portfolio *and* the bank's actual expectations of the losses which will be suffered on that portfolio (with the expectation of some surplus profit in on top of that). However, the losses which will be incurred on the securitised exposures will be the same whether or not the securitisation occurs, and thus those losses will *always* encumber the originator's profit and loss account. Thus, when assessing the impact of SES, it is not appropriate to compare the effect of the SES on the originator's profits without taking into account the impact which those losses would have on those profits anyway. Similarly, when considering whether SES amounts to a form of credit enhancement, it is not appropriate to ignore the offsetting effect of the income to be generated by the portfolio, particularly where, as is usually the case, the SES is calculated by reference to the performing balance of the portfolio.

- Fourthly, and following from the preceding point, rather than being considered as credit enhancement *per se*, SES should only be considered to constitute credit enhancement to the extent that the amount of SES exceeds a certain amount. The role of the regulatory technical standards should be to determine what that amount is in the case of a given portfolio.

There also needs to be a recognition that investors in SRT transactions do not expect to cover the losses which they anticipate will be suffered (the "investor anticipated losses", as distinct from the regulatory expected and unexpected losses). Put another way, investors expect to achieve a positive overall return from their investment in a securitisation, *after* taking into account those investor anticipated losses. They would only experience an overall negative return where they (ie, the investors) have under-estimated what those eventual losses would be. Thus, investors expect to be paid a coupon which over the life of the transaction will compensate them the losses which they anticipate will be incurred. The economic basis for a SRT transaction is that the investor anticipated losses is much lower than that the level of expected losses and unexpected losses which is implied by the capital framework, thereby meaning that the cost to the bank of paying the investors to bear those losses is less than the cost to the bank of funding the capital which it would otherwise be required to hold against the securitised exposures. There is nothing inappropriate in this; indeed, the same considerations apply at a bank-wide level for any capital instruments issued by the bank (ie, investors do not invest in bank capital instruments if they expect an overall negative return). It is not a form of regulatory arbitrage. On the contrary, the bank has substituted for the uncertainty that defaults on the securitised exposures could at any time be greater than expected, the certainty of knowing that so long as it pays the fixed coupon amounts, those excess losses will be borne by investors.

Against this backdrop, SES is simply another way in which the originator can cover investors for the investor anticipated losses. That is, without the use of SES, the investor would require a higher coupon. However, unlike the coupon, SES is not *actually* paid to investors, and thus if the losses do not materialise, it allows the bank to recapture the difference between the amount of investor anticipated losses the amount of losses actually anticipated by the bank. Thus, SES allows for the overall cost of the securitisation to be lower than if those losses had to be covered through a higher coupon.

In a similar vein SES is more efficient (and therefore cheaper) for the bank than a retained first loss tranche, which would be the other alternative way to reduce the coupon. SES is only contributed by the bank if losses actually materialise, and the amount of contribution in any one year is capped at a small percentage of the performing balance of the portfolio. This timing difference is vitally important. Where the bank retains a first loss tranche, it is exposed to the risk of significant losses being front-loaded, before it has time to generate income from the portfolio to offset those losses. In contrast, because SES only accrues over the life of the transaction, and should always be significantly less than the amount of income accruing on the securitised portfolio in each year, the bank will at no time be contributing more credit enhancement to the investors than the income it has received of the portfolio in that year. If there is an unexpectedly high level of losses suffered on the securitised exposures early in the life of the transaction, most of those losses will be borne by the investors, who will not subsequently be able to recoup them from future SES. Thus, AFME members disagree with the concerns expressed by the EBA that SES encumbers the originator's P&L account (see paragraphs 118 and 216 of the SRT Report and paragraph 4 and Section 5.1(A) of the Consultation Paper). Because the future income from the securitised exposures is also not recorded in the originator's P&L prior to it being received, it would be more accurate to say that the SES *reduces* the future income which will be generated by the securitised portfolio (in a quantum equal to the amount that future losses would have otherwise impacted the P&L of the originator in the absence of the securitisation).

Against this backdrop, we set out in our response to Question 11, below our proposed approach to calculating the exposure value of SES in a way which is workable, proportionate, achieves the goal of preventing regulatory arbitrage *and* is consistent with the Level 1 text of Article 248(1)(e).

We also set out in our responses to Questions 1 to 10, below, the reasons why we consider both the Full Model Approach and the Simplified Model Approach set out in the Draft RTS to be *fundamentally flawed*, even on their own terms.

Our responses to Questions 1 to 10 must be read against the above observations, and AFME members' view that neither the Full Model Approach nor the Simplified Approach are fit for purpose. These responses are intended to illustrate why we consider that to be the case, and should not be taken as indicating that AFME members believe that modifications to either of those approaches would produce an acceptable or workable approach to the calculation of the exposure value of SES.

Q1. *Do respondents find the provisions clear enough or would any additional clarification be needed on any aspect?*

Generally, these provisions are clear. However, the definition of a "Use-it-or-lose-it mechanism" is overly restrictive. There are broadly two types of UIOLI mechanism which are commonly used in synthetic securitisations. The first approach, which is reflected in the draft definition, is where losses are allocated against the synthetic excess spread which accrues in the period in which the loss is actually realised, regardless of when the credit event leading to that loss occurred. The second approach involves losses being allocated against the synthetic excess spread which accrues during same the period in which the credit event occurs, even though those losses may not be realised until a later period. AFME members consider that *both* of these mechanisms should be captured by the definition of UIOLI, and thus benefit from the lower Scalar under the Simplified Model. Whether one approach will lead to a greater amount of future losses being absorbed by SES than the other approach cannot be determined in advance, because this will ultimately depend on whether the initial losses determined at the time of the credit event (and thus allocated against the excess spread that accrues in the same period as that in which the credit event occurs) are greater than or lesser than the final losses determined at the end of the work-out process). However, to the extent that the initial loss is a fair approximation of the final loss, or is a conservative estimate meaning the final loss is likely to be lower, then it would mean that the actual losses to be absorbed by that SES would be lower than that initially allocated, meaning it is unlikely that there would actually be significant additional losses absorbed by that carried forward SES. Such an approach would be consistent with the STS requirements for a settlement of estimated losses at the occurrence of a credit event on the basis of Loss-Given-Default estimates or accounting provisions. Further, once a credit event has actually occurred, any SES which accrues in that period which is carried forward pending realisation of the final losses for that period will be captured by limb (ii) of Article 248(1)(e) of the CRR, meaning that it is still being taken into account in calculating the overall exposure value of the SES.

Regardless of which of the foregoing approaches is adopted, there are also three broad ways in which SES is calculated, all of which should be classified as a UIOLI mechanic:

- First, where SES is calculated on an annual basis, by reference to the outstanding portfolio balance at the beginning of the period. Unused SES from one annual period is not carried forward into the next annual period.

- Secondly, where SES is calculated for smaller sub-divisions within an annual period (eg., monthly or quarterly) by reference to the outstanding portfolio balance at the beginning of that sub-period, with the total amount of SES available for the annual period being the sum of the amounts calculated for each sub-period. Unused SES from one annual period is not carried forward into the next annual period.

- Thirdly, where SES is calculated for periods of less than 12 months (eg., monthly or quarterly) by reference to the outstanding portfolio balance at the beginning of those periods, and where each amount of SES calculated is available to cover losses for the forthcoming 12 months from the date

of calculation. This "rolling" approach is actually that used by the EIF in most of their synthetic securitisation transactions and is widely understood in the market to be a form of UILOI SES.

The current definition of UIOLI in Article 1(1) of the Draft RTS only appears to capture the first of these three approaches.

Please also see our comments in relation to the loss distribution scenarios defined in Articles 1(3)–(5) in our response to Question 6, below.

Q2. *Do you agree with the possibility of choosing between the full and the simplified model approaches in a consistent manner?*

As discussed in our General Observations, above, AFME members do not consider that either the Full Model Approach nor the Simplified Model Approach represent reasonable, proportionate or necessary approaches to the calculation of the exposure value of SES, and if implemented in the form proposed in the Draft RTS they will result in virtually all synthetic securitisations using SES becoming completely uneconomic for the originator. Our comments which follow must therefore be read against this general view of the Draft RTS.

Please also refer to our responses to Questions 3 and 10, below.

AFME members do not agree that an institution should be required to apply either the Full Model Approach or the Simplified Model Approach to *all* of its securitisations at the same time. There may be some securitisations for which the difference between the outcome under the Full Model Approach and the Simplified Model Approach is minimal, in which case there is little benefit for the institution in calculating the exposure value under the Full Model Approach given the greater operational and auditing burden associated with that. There may also be cases where it not possible for an institution to calculate all the components of the Full Model Approach with a sufficient level of certainty to justify using the Full Model Approach. This may particularly be the case for large banking institutions which operate in multiple jurisdictions and/or across many different market segments, with different parts of the institution having differing levels of experience and resources devoted to securitisation, or applying models with different levels of sophistication to different asset classes. There is no prudential benefit to be achieved by forcing such institutions to adopt the same approach for all their securitisations.

It is also inappropriate that an institution should only be able to change its approach on an annual basis with effect from 1 January in each year. For example, what would be the implications for an institution which is currently applying the Full Model Approach if it originates a new securitisation for which it is unable to calculate the exposure value of SES under the Full Model Approach?

We understand from comments made by the EBA at the Public Hearing on 6 September 2022, that one of the reasons for the EBA having specified a Scalar of 0.8 for where the Simplified Model Approach is applied to a UIOLI SES mechanism is because this was necessary in to avoid an outcome where the Simplified Model Approach produced a lower exposure value than the Full Model Approach. AFME members disagree with this conclusion. While in some circumstances the Full Model Approach will produce a slightly lower exposure value than the Simplified Model Approach, that will not always be the case. For example, in a portfolio where the expected losses are higher than the amount of SES, because the Full Model Approach allocates up to the full amount of expected losses to the SES, whereas the Simplified Model Approach applies a Scalar where UIOLI applies, the actual exposure value of SES can end up being significantly lower under the Simplified Model Approach, particularly where there is an initial replenishment period, given the effect if the assumptions in Article 3 of the

DRAFT around replenishment. See the example at the end of this response for an illustration of this effect.

The CRR framework works on the basis that where there are multiple methodologies available, the more nuanced or complex methodology (eg., IRB Approach v Standardised Approach, Financial Collateral Comprehensive Approach v Financial Collateral Simplified Approach, SEC-IRBA v SEC-SA, Advanced Measurement Approach v Standardised Approach or Basic Indicator Approach, etc.) generally produces a lower capital requirement for the institution. While AFME members acknowledge that this is not *always* the case, as a general principle that does hold true. In this case, however, it appears that it depends very much on the nature of the securitised portfolio as to whether the Full Model Approach or the Simplified Model Approach produces a greater or lesser value for exposure value, meaning that it is impossible for an institution to determine in advance whether it should choose to apply the Full Model Approach or the Simplified Model Approach to all of its securitisations, which may change from time to time. This also highlights the fact that the analysis underpinning the Full Model Approach is flawed.

At a more technical level, given that the election of the chosen approach is to be notified to the competent authority by 15 October in each year, to take effect from 1 January the following year, it is not clear what should happen in the first year in which these requirements apply. Would the requirement to calculate the exposure value of SES not apply at all until the 1 January following the first 15 October which occurs after the date on which the RTS enter into force? (For example, if the RTS enter into force in April 2023, the requirement would apply from 1 January 2024 (with the first election notified by 15 October 2023), but if the RTS enter into force in November 2023, they would not apply until 1 January 2025 (with the first election notified by 15 October 2024)? In this regard, please see also our comments in response to Question 13, below, in relation to the need for grandfathering and a phase-in period.

Finally, on the basis that AFME members do not consider that there is any benefit in having two alternative approaches, the annual review specified in Article 2(4) of the Draft RTS should not be necessary.

***Q3**. Instead, would you favour that the RTS consider only one method (i.e. the full model approach or the simplified model approach) for the calculation of the exposure value of the synthetic excess spread of the future periods?*

In light of our both our General Observations, and our response to Question 2, above, AFME members agree that a single approach should be provided. However, that approach should be the Alternative Approach as discussed in our response to Question 11, below.

***Q4**. Do you agree with the specifications of the asset model made in Article 3?*

As discussed in our General Observations, above, AFME members do not consider that the Full Model Approach represents a reasonable, proportionate or necessary approach to the calculation of the exposure value of SES, and if implemented in the form proposed in the Draft RTS it will result in virtually all synthetic securitisations using SES becoming completely uneconomic for the originator. Our comments which follow must therefore be read against this general view of the Draft RTS.

First, in relation to Article 3(4), it is not appropriate to assume that revolving exposures will remain drawn at a fixed amount for the remaining term of those exposures. This produces an artificial figure

(which could be either too high or too low). Instead, institutions should be permitted to model the expected drawings under revolving facilities by reference to historical data or expected behavioural assumptions.

Following from, and related to, the previous point, it is not appropriate that institutions are not permitted to take into account expected prepayments for the securitised exposures, as specified in Article 3(6). The observed experience is that many securitised exposures do prepay, and excluding such prepayments from the calculation produces an inappropriately conservative outcome.

We note previous discussions with the EBA on this point in the context of the Guidelines on WAM (EBA/GL/2020/04), as well as the EBA's reference to the EBA Guidelines on STS for ABCP Securitisation (EBA/GL/2018/08) in Recital (8) to the Draft RTS and at the Public Hearing, both of which similarly do not permit the prepayment assumptions to be taken into account. In that regard, the EBA will recall that AFME members strongly disagreed with the inability to take prepayment assumptions into account for synthetic securitisations[3] (in contrast to traditional securitisations where prepayments *are* taken account), although we understood from those previous discussions that the EBA had taken the view that it was constrained in this regard by the level 1 text of the CRR. We do not think that any such constraint can be said to arise from the level 1 text of Article 248(1)(e) of the CRR. On the contrary, the whole purpose of the RTS under Article 248(4) of the CRR is to enable an accurate measure of losses to be taken into account, which is not the case if the starting assumption as to the size of the remaining securitised portfolio for each future period requires an institution to assume that every securitised exposure will only repay on its latest possible scheduled maturity date. In relation to the EBA's reference to the Guidelines on STS for ABCP Securitisation, the calculation of the weighted average life of the pool in that context is being done for a completely different purpose, and is to protect investors against the consequences of exposures not prepaying when they are expected to do so. Given that the exposure value of the SES has no impact on investors at all, there is no reason why a similar approach should be adopted here.

In relation to Article 3(5)(b) of the Draft RTS, it is not clear how is this intended to work where the securitised exposures amortise over time. It would appear that this article assumes that as each repayment is made, it is immediately replenished with a new, non-amortising exposure the maturity of which is equal to the longest eligible maturity (without regard to the effect of concentration limits which may actually require exposure added to the portfolio at that time to have a significantly shorter maturity), the overall effect of which is to turn such amortising exposures into bullet exposures with a maturity equal to a date after the scheduled end of the revolving period which is equal to the longest tenor of exposures that can be included at the time of that repayment. This does not take into account the expectation that the loans that are added through the replenishment process may also be amortising (including amortising by virtue of the contractual eligibility criteria), such that the weighted average life of those loans is much shorter than their final maturity date. Similarly, in the case of Article 3(5)(c), does this mean no assumed replenishment applies to the extent that these exposures amortise during the revolving period? The impact would be particularly high in transactions where there is a contractual undertaking to only replenish with amortising loans. This is an example of how an approach which may superficially appear logical (ie, to adjust the actual amortisation profile to reflect potential replenishment) is actually a very blunt instrument which will in many cases produce an outcome which is simply not reflective of the likely actual amortisation of the securitised portfolio, and therefore not a sound basis for determining the bank's capital requirements in connection with the securitised portfolio.

[3] Insert cross-reference to AFME submission on this point.

On a more minor point, in relation to Article 3(7), we assume that the reference to losses being assumed to happen "in the same period *within the expected maturity of the transaction*" means that, where the 5-year cap on expected maturity applies under Article 1(3), losses which would be expected to occur more than 5 years after the date of determination will effectively be disregarded for the purpose of the Full Model Approach calculations, but this needs to be clarified.

It is also not clear why the calculation in Article 3 includes both principal and interest payments on the securitised exposures, given that most synthetic securitisations do not actually provide protection in respect of interest amounts and, by definition, interest payments will not affect the maturity of the securitised exposures.

We note that there is no question relating to Article 4 of the Draft RTS. Our only comment on this Article is that, where para (a) applies, there should be no need for the originator to undertake the calculations in Article 3, as they will not have any impact on the amount of SES contractually designated.

Q5. *Do you agree with the specifications for the determination of the relevant losses made in Article 5?*

AFME Members do not consider that the method for determining the relevant losses in Article 5 is appropriate.

In the case of originators which apply the IRB Approach, there are biases in the IRB models which mean that they generally overstate the actual expected losses. While this is logical when applied over a one-year time horizon, it is not logical when applied to the lifetime of the portfolio, as it fails to take into account fluctuations that occur in the actual realised losses year-on-year as compared with those expected losses. That is, unless the SES is set at a level higher than the expected losses (which is be rare, and not permitted in the case of a STS synthetic securitisation (see Article 26e(7) of the EUSR), this means that more of the over-estimate baked into the IRB model will be captured in each period without any equal offsetting recognition that in some periods the realised losses will be lower than the expected losses.

Secondly, many originators are required to apply add-ons in their IRB models that increase the regulatory expected losses, not for reasons that are specifically related to the performance of the securitised exposures. Again, this has the effect of inflating the expected losses relative to the likely actual realised losses, with the same result as that described in the preceding paragraph.

It is also not clear how the use of "new specific credit risk adjustment" referred to in Article 5(1)(b)(i) is supposed to be used for this purpose for originators applying the Standardised Approach. Under IFRS 9, for assets in Stage 1, banks are required to calculate impairments on a one-year basis, and they only move to lifetime impairments for exposures that are classified as being in Stage 2. Does this mean that originators are required that amounts equal to its Stage 1 impairments on the securitised exposures will actually be incurred in each year through the WAL of the securitised portfolio? If not, what is meant by "new specific credit risk adjustments"? Similarly, how is an originator meant to decide that the use of new specific credit risk adjustments results in a loss coverage that is "not sufficiently representative", such that it should model the expected losses amounts using other internal risk parameters in accordance with Article 5(1)(b)(ii)? Once again, this is an illustration of how the methodology is not fit for purpose. While the reference to the applicable accounting framework is superficially logical, the reality is it is completely unclear how that is to work in practice.

Please also see our response to Question 6, below, for more detailed analysis on why the method of determining and allocating losses under the Full Model Approach is flawed.

Q6. *Do you agree with the calculation of the exposure value of synthetic excess spread for future periods made in Article 6?*

AFME members have two key objections to the method of calculating the exposure value of SES under Article 6, as well as some practical question in relation to how the scenarios are to work in practice.

Incentivising arbitrage

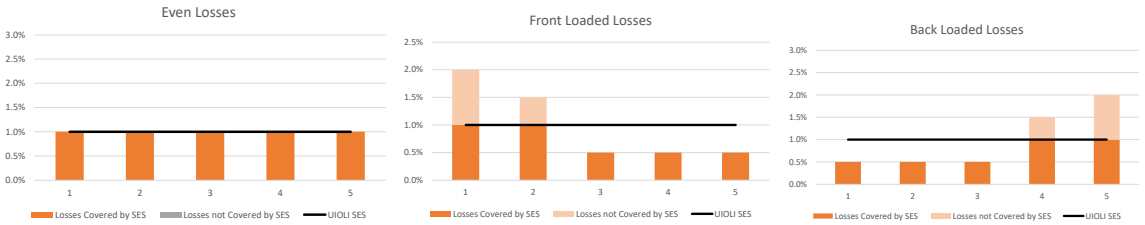
AMFE members consider that the method of allocating losses for a given period actually incentivises regulatory arbitrage in some circumstances. This is because, by counting only that portion of the SES which corresponds to the losses determined pursuant to Article 5, there is no exposure value associated to SES in excess of those expected losses.

In most cases this would not be an issue, because the SES is usually set at a level at or below the expected losses. Indeed, in the case of a STS synthetic securitisation, Article 26e(7) prohibits SES in excess of expected losses, and even for non-STS synthetic securitisations it would be extremely rare for that to be the case. Nevertheless, if an originator wanted to engage in regulatory arbitrage, it could do so by increasing the SES in a non-STS synthetic securitisation to be significantly in excess of the expected losses, without that having any impact on the exposure value of the SES under the Full Model Approach (though it would increase the exposure value under the Simplified Model Approach). While the commensurate risk transfer test, and indeed the mechanistic tests, under Article 245(2) of the CRR will act as a counterweight to avoid such behaviour, the fact remains that the design of the Full Model Approach actually incentivises this behaviour. This is presumably an unintended consequence of the Full Model Approach correctly not simply applying the contractual rate of SES for each future period. However, it serves once again to highlight how the Full Model Approach is fundamentally flawed and not fit for purpose.

Shortcomings in the underlying methodology

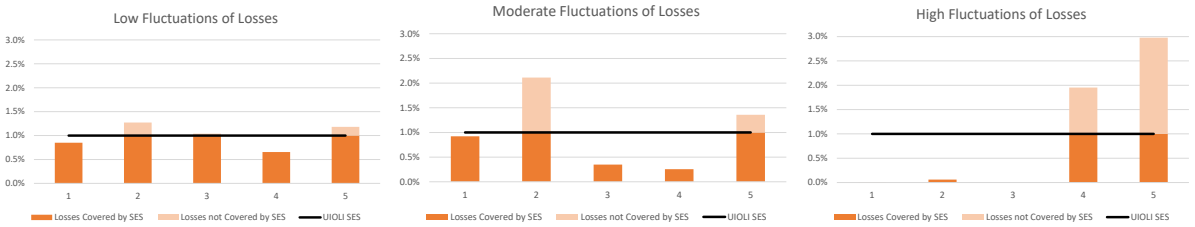
Fluctuations of Losses and Utilisation of SES

By way of illustration, consider a transaction with 5y bullet assets, with a 1% annual EL, and 1% UIOLI SES. Under the proposed scenarios from the Consultation Paper, the projected utilisation of the SES can be illustrated as follows:



It is easy to check that in these scenarios the proportion of SES used is, respectively, 100%, 70% and 70%, and applying equal weighting, this does indeed result in 80% which would appear to support the use of the 0.8 scalar.

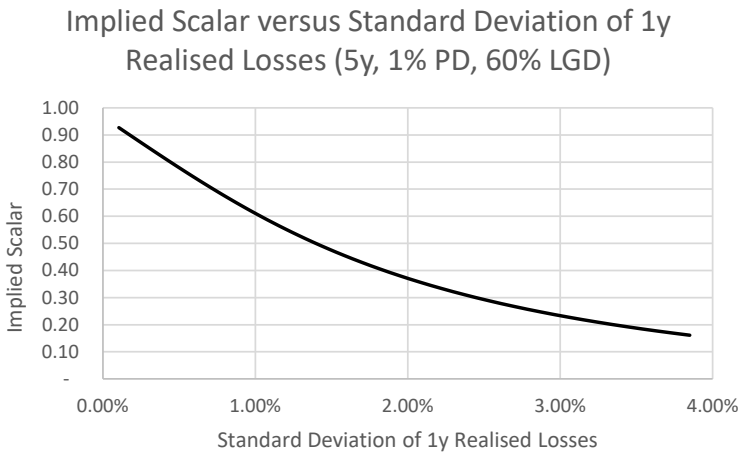
Applying some random variation to the realised losses, generating fluctuations, whilst still having similar total losses over the transaction life, some further scenarios can be generated[4] with low, moderate and high levels of fluctuation of losses:



For these illustrative examples, in the low case, 90% of the SES is utilised, whereas in the moderate case, 71% is, and in the high case, 41%.

The reason for this sensitivity to level of fluctuation for UOILI SES is that when the realised losses in a year under-shoot the available SES, the remaining unutilised SES is discarded and not subsequently available, whilst any exceedance of annual realised losses over the available SES are not covered by the SES anyway. The greater the level of fluctuations, the more under-shoot (and over-shoot) will occur for the same level of EL, and hence the less SES is expected to be utilised.

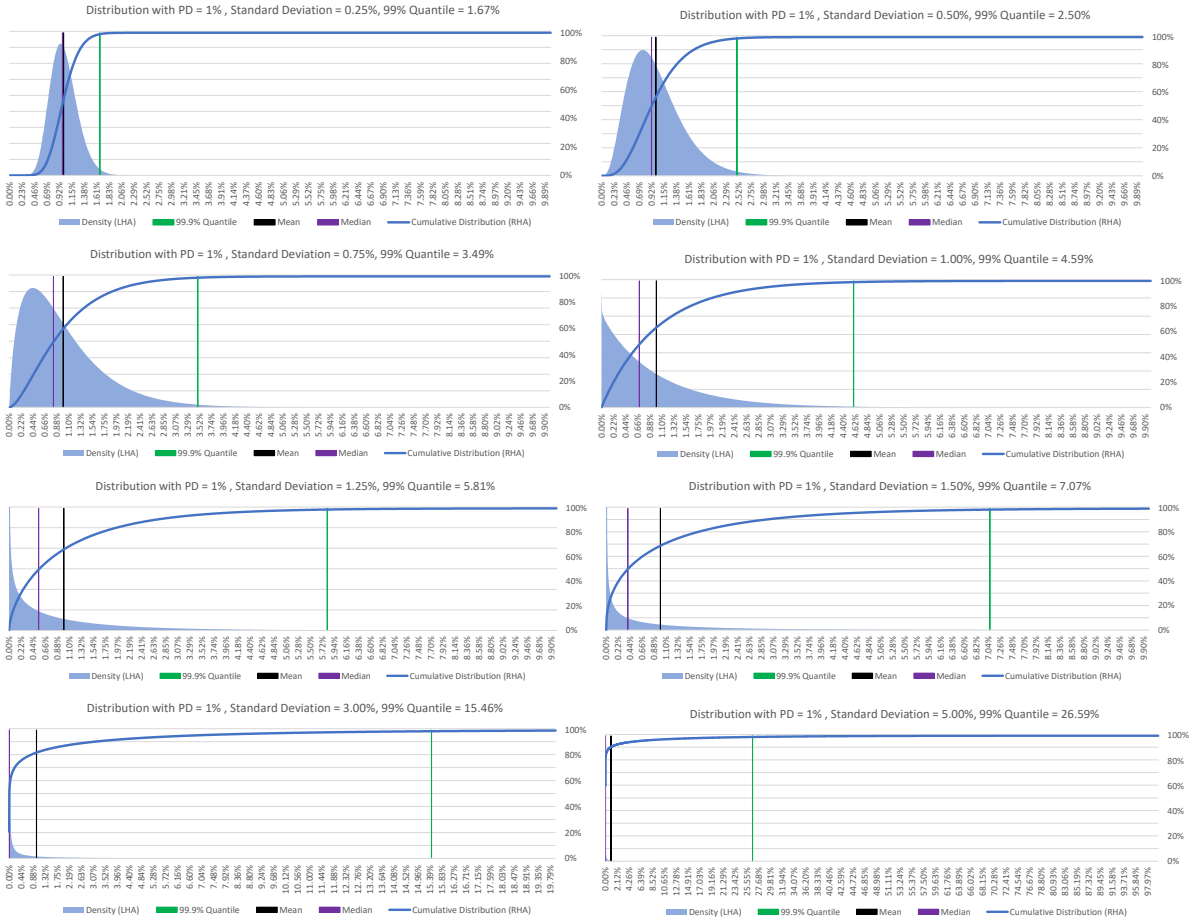
Constructing a simple mathematical model for fluctuations of losses permits the calculation of a chart such as the following, which illustrates the relationship between Implied Scalar (i.e. the expected utilisation of the SES divided by the Simplified SES calculation) in the case of a 5y bullet portfolio with 1% per annum EL and 60% LGD. Similar charts can readily be created for portfolios with other characteristics, but the generate appearance would be similar.



From this chart it can be observed that the 0.80 scalar is equivalent to a standard deviation of realised annual losses of approximately 0.45% representing 45% of the expected annual losses. Whilst this represents a significant proportion of the expected annual losses, it is rather low compared to typical expect calibrations of loss distributions, in that it would result in a distribution that is relatively un-skewed with small tail losses, which could be considered unreasonably optimistic about the rarity of extreme credit events.

[4] The model used to generate these fluctuations is a gamma-distribution based model described in more detail in the appendix

To provide some intuition regarding the shape of annual realised loss distributions for different standard deviations, see the following charts that illustrate the shape of the distribution, the location of the median and 99% quantile (1 in 100 events) for various parameter values. Note that for low standard deviations, the distribution resembles a well-known, one-humped shape, with tails tending to zero at small and high levels of losses. As the standard deviation increases (as a proportion of the expected value, or mean) the distributions become increasingly skewed with a more pronounced peak at very low levels of loss, and a thicker tail into higher levels of loss, with an increased likelihood of extreme events. This reflects that probabilities cannot be negative, so that this is the only way to generate increased dispersion. It is worth recalling that it is widely believe that, in practise, credit events are heavily skewed, with the average (expected) loss on a portfolio being heavily influence (even dominated) by relatively rare extreme events, such as the crisis of 2007-2009. Under such circumstances the realised losses can exceed average expected losses by a multiple of 3 or 4 (or more) and hence there is some justification for expecting realistic loss distributions to have heavily skewed tails.



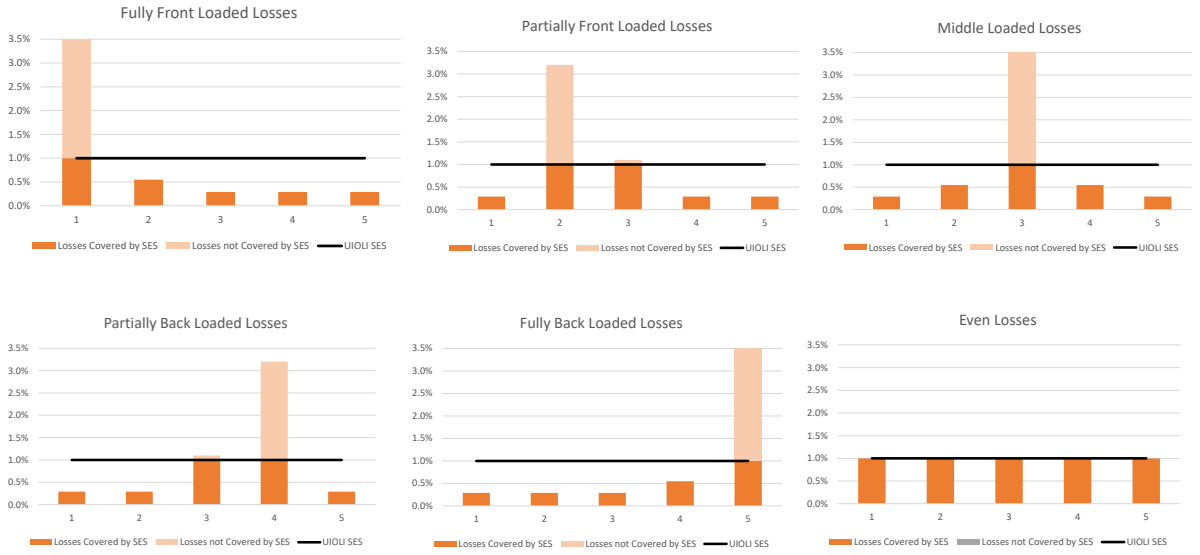
Alternative Scenarios

The range of scenarios for the full model approach should be consistent with the fluctuations in losses that are broadly anticipated in the regulatory framework. There are credible reasons to consider that the probability distribution of realised losses (over one year) should have a standard distribution comparable to the expected loss (e.g. a standard deviation of 1% in the charts above). Therefore, we propose two alternative collections of scenarios which are reasonably easy to specify, and are similar to those described in the consultation paper, but which have more consistent properties.

Scenario 1

Scenario Name	Description
1. Fully Front Loaded	7/9 (78%) of the total expected losses expected to occur during the expected maturity are equally spread over the first 2/9 (22%) of such expected maturity, with the remaining 2/9 of the expected losses spread over the remaining 7/9 of the expected maturity
2. Partially Front Loaded	7/9 of the total expected losses expected to occur during the expected maturity are equally spread over the second 2/9 of such expected maturity, with the remaining 2/9 of the expected losses spread over the remaining 7/9.
3. Middle Loaded	7/9 of the total expected losses expected to occur during the expected maturity are equally spread over the middle 2/9 of such expected maturity, with the remaining 2/9 of the expected losses spread over the remaining 7/9
4. Partially Back Loaded	7/9 of the total expected losses expected to occur during the expected maturity are equally spread over the penultimate 2/9 of such expected maturity, with the remaining 2/9 of the expected losses spread over the remaining 7/9.
5. Fully Back Loaded	7/9 of the total expected losses expected to occur during the expected maturity are equally spread over the last 2/9 of such expected maturity, with the remaining 2/9 of the expected losses spread over the remaining 7/9 of the expected maturity
6. Evenly Distributed	As for the Consultation Paper

For a transaction with 5y bullet assets, with a 1% annual EL, and 1% UIOLI SES, the projected utilisation of the SES for these scenarios can be illustrated as follows:



Each of these scenarios has total losses equal to the expected loss, but the standard deviation of annual losses is close to the expected loss (about 1%) which is more consistent with regulatory

expectations of unexpected losses (see comparison with risk weights below). Another way to compare these scenarios to those propose in the Paper, is that the standard deviation of annual realised losses implicit in those in the Paper is only about 50% of the annual expected loss, which is substantially lower than would be consistent with broader regulatory expectations.

Scenario 2

Scenario Name	Description
1. Front Loaded	4/5 (80%) of the total expected losses expected to occur during the expected maturity are equally spread over the first 1/5 (20%) of such expected maturity, with the remaining 1/5 of the expected losses spread over the remaining 4/5 of the expected maturity
2. Back Loaded	4/5 of the total expected losses expected to occur during the expected maturity are equally spread over the last 1/5 of such expected maturity, with the remaining 1/5 of the expected losses spread over the remaining 4/5 of the expected maturity
3. Evenly Distributed	As for the Consultation Paper

These scenarios are obviously simpler and less granular in detail that those in first set of scenarios, but are more similar in construction to those in the Consultation Paper. The standard deviation of annual losses in this case is slightly higher than the expected loss, and hence this option would be marginally less prudent than Scenario 1.

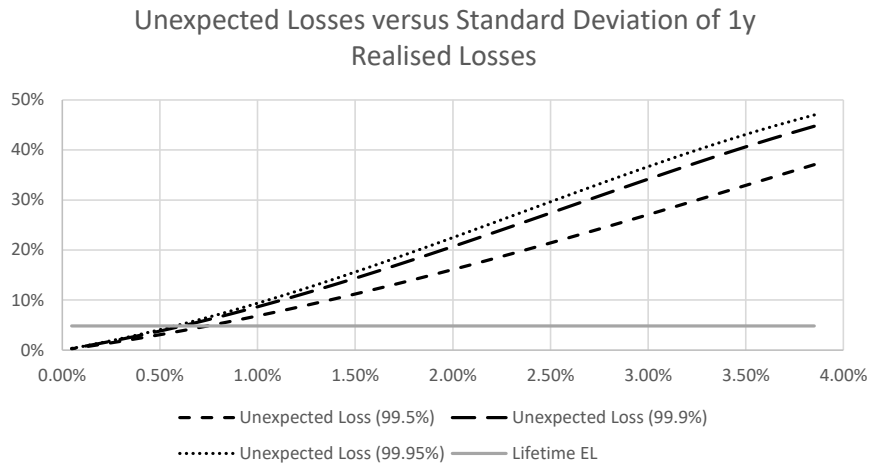
The average utilisation of SES across these scenarios is approximately 0.60, and hence a scalar of 0.60x for the simplified approach would be appropriate in order to be consistent with these scenarios.

Fluctuations of Losses and Lifetime Unexpected Losses

The level of fluctuation of losses modelled or assumed in a portfolio also directly impacts the determination of unexpected losses; the greater the degree of fluctuations, the more unexpected losses would be expected to be, because unexpected losses represent the degree to which realised losses over the lifetime may exceed the EL. Holding the EL constant, increasing fluctuations will both increase the likelihood of under-shoot or over-shoot of the EL, both for individual years, and over the life of the transaction.

A widely used measure for unexpected loss is the amount by which a certain quantile of the lifetime loss distribution exceeds the EL. This is equivalent to looking into the adverse tail of the distribution of losses.

Again, considering the case of a 5y bullet portfolio with 1% per annum EL and 60% LGD, the following chart shows the relationship between the standard deviation of 1y realised losses and lifetime unexpected losses at 99.5%, 99.9% and 99.95% levels, derived mathematically for the relevant distributions. Note that for higher levels of fluctuation the unexpected loss quantiles can substantially exceed the expected loss level, as would be expected, since this represents the predominance of unexpected adverse events in reflecting credit risk.



Fluctuations of Losses, Lifetime Unexpected Losses and Risk Weights

The risk weights assigned by the Basel Rules and Capital Requirements Regulation[5] are intended to reflect capital requirements so as to permit banks (and similarly regulated institutions) to absorb unexpected losses without losses putting depositors (or other preferential lenders) to the entity at risk. In particular, the guidance provided by the EBA for undertaking calculations relating to unexpected losses for SRT purposes, suggests using the standardised risk weight multiplied by 8% as a means of estimating unexpected losses[6]. Elsewhere, there are also indications that it is appropriate to consider risk weights as reflecting a 99.9% quantile of the lifetime loss distribution[7] and in any case this is certainly a sensible measure to quantify and describe the adverse tail risk in a distribution of losses.
Putting this together, it therefore seems reasonable to consider the following relationship between standardised risk weights and unexpected losses:

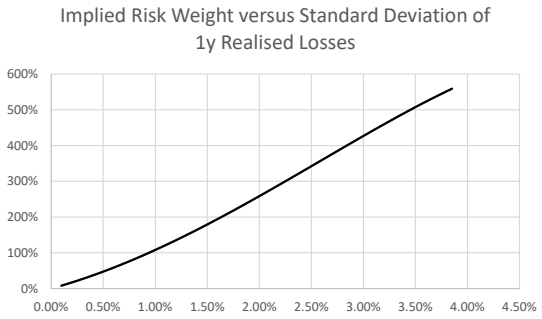
$$\text{Quantile}(99.9\%) \approx 8\% \times \text{Risk Weight}$$

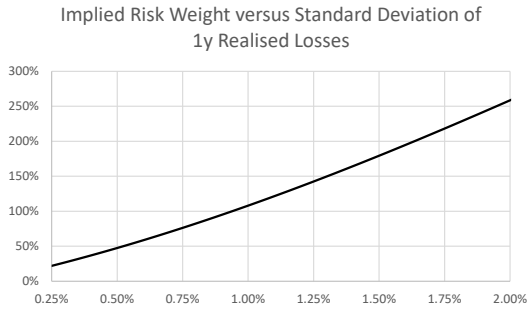
Or alternatively

$$\text{Quantile}(99.9\%) \times 12.5 \approx \text{Risk Weight}$$

Applying this to the data underlying the chart illustrated above, shows that one would expect the following relationship between standard deviation of realised loss and risk weight for the 5y portfolio considered, where the second chart shows a smaller portion of the graph:

[5] EU Regulation 575/2013 as subsequently amended ("CRR")
[6] E.g. paragraph 172 of EBA-DP-2017-03
[7] E.g. CRR Article 153(1)(iii)

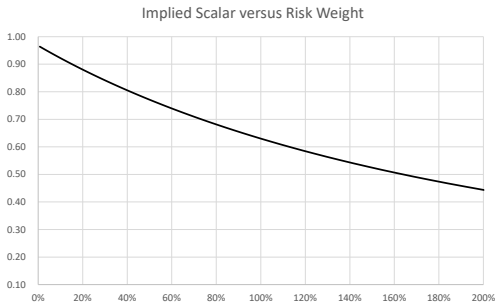




From this we can see that, in this case, a 100% risk weight would be expected to be consistent with fluctuations in annual losses represented by a standard deviation of approximately 1.00%.

Risk Weights and Implied Scalar

Putting together the relationship between risk weights, unexpected losses, fluctuations in realised losses, and determination of appropriate values of the UIOLI SES scalar, it is possible to infer, for a particular portfolio (based on term, annual PD, LGD etc.) what the relationship should be between risk weight and SES scalar, in order for them to reflect consistent expectations about the underlying statistical behaviour of the portfolio. The following chart illustrates this:



This shows that the 0.8 scalar would be consistent with a 40% risk weight on the underlying portfolio, whereas for a 100% risk weight (which applies to many categories of exposure under the standardised approach) the appropriate scalar would be close to 0.6.

Carrying out equivalent calculations for a range of portfolio terms and ELs (in each case assuming bullets and 60% LGD) gives rise to the following estimates for appropriate scalars consistent with 100% standardised risk weights:

Term (years)	**Annual Expected Loss**			
	0.25%	**0.5%**	**1.0%**	**1.5%**
2	0.22	0.42	0.59	0.67
3	0.24	0.44	0.61	0.68
5	0.25	0.46	0.62	0.68
10	0.30	0.51	0.66	0.72

As can readily be seen, all of these are smaller than 0.8, and in the case of the lower EL portfolios, substantially lower, indicating that the use of a single 0.80 value for the scalar is inconsistent with the calibration of unexpected loss implied standardised risk weights.

Conclusion

The use of three equally weighted scenarios (even, front loaded and back loaded) is overly simplistic in determining appropriate values for exposure of UIOLI SES and significantly over-states the capital requirements versus calibration against fluctuation of realised losses taking account of the implied magnitude of unexpected losses consistent with standardised risk weights. Standardised risk weights imply a considerably greater degree of fluctuation, lower utilisation of UIOLI SES than the equally weighted scenarios imply, and hence that lower exposures amounts would be appropriate. An alternative set of six scenarios with more appropriate calibration would be more consistent with broader regulatory considerations and would appropriately estimate the exposure associated with UIOLI SES in a readily calculable way, and would further be consistent with value of 0.60 for the scalar in the simplified approach (although, as noted elsewhere, AFME members still consider a Scalar of even 0.60 to be unnecessarily high). It is worth noting that it is challenging to observe this in empirical observation of historical data, precisely because of the rarity of the extreme events driving the tail of the distribution; however, there are indications that under crises losses can be a multiple of expected losses.[8]

This use of a single value of 0.8 for the scalar in determining the exposure amount for UIOLI SES is inappropriate for similar reasons because of this implies a lower level of fluctuation that would be consistent with the calibration of standardised risk weights.

Practical considerations

At a more practical level, how are the loss distribution scenarios defined in Articles 1(3)–(5) intended to work given the requirement in Article 5 to calculate the losses for each future period? For example, in the case of the front-loaded scenario, is the intention that two-thirds of the aggregate losses determined pursuant to Article 5 are allocated evenly to each period in the first third of the expected maturity, with one-third of the aggregate losses allocated evenly to each period in the remaining two-thirds of the expected maturity (and vice versa for the back-loaded scenario)?

In the case of the evenly-loaded scenario, is the intention for losses to be allocated to the specific period for which they are determined pursuant to Article 5, or is the intention for the same portion of the aggregate losses determined pursuant to Article 5 to be allocated to each period? AFME members are of the view that for this scenario, losses should be allocated to the actual period for which they are determined. If so, what is the basis for adopting this approach?

Q7. *Shall the average of the scenarios be made in a different way for UIOLI and trapped mechanisms (e.g. back-loaded and evenly-loaded only for UIOLI mechanisms, and front-loaded and evenly-loaded for trapped mechanisms)?*

Please see the technical response above in response to Question 6.

[8] E.g. S&P historical performance data (found here: https://www.spglobal.com/ratings/en/research/articles/210407-default-transition-and-recovery-2020-annual-global-corporate-default-and-rating-transition-study-11900573) suggests that peak unexpected defaults in 2009 were more than 1.8x average defaults

Q8. *Do you agree with the specification of the simplified model approach made in Article 7?*

In addition to the points already made above, AFME members have a number of comments on the Simplified Model Approach.

First, the formula currently refers to the contractual amount of SES designed for the *next* period, to be determined in accordance with Article 4. By implication, where the amount of SES is determined by reference to the size of the securitised portfolio, this also means that the originator will need to undertake the calculations in Article 3 for the next period. Given that the Simplified Model Approach is a blunt calculation, there is little benefit to be gained from running the calculations in Article 3 for a single period, and requiring the consequential review of those calculations under Article 2(4). Rather, it would make more sense to base the calculation on the actual amount of SES already calculated for the *current* period.

Secondly, consistent with our comments on Article 3(6) above, AFME members do not think it appropriate the prepayment assumptions may not be taken into account in the calculation of WAL_t under the Simplified Model Approach. Even though it is appreciated that the Simplified Model Approach is not intended to be as nuanced as the Full Model Approach, this still produces an overly conservative outcome that is not truly reflective of the actual amount of SES that would be used to absorb losses over the remaining expected maturity of the securitisation. Further, given the comments in our response on Question 4, above, it is not clear how the WAL_t would *actually* be calculated in the case of a replenishment period as the approach of simply adding the weighted average life of the reference portfolio at the end of the replenishment period to the to the remaining replenishment period is essentially nothing more than a hypothetical calculation.

Q9. *Do you consider that the formula can be further simplified (e.g. by using the maturity of the credit protection multiplied by a conservative scalar instead of WAL)?*

AFME members do not agree that it would be appropriate to replace the WAL with a scalar applied to the maturity of the credit protection. The actual amortisation of a securitised portfolio will vary greatly depending on the nature of the securitised exposures and the portfolio make-up. The WAL calculation, while imperfect for the reasons discussed in our response to Question 5, above, at least attempts to take this into account in a way a conservative scalar applied to the scheduled maturity of the credit protection is simply unable to do.

Q10. *Do you agree with the scalar assigned for UIOLI mechanisms? If not, please provide empirical evidence that justifies a different scalar based on the different loss absorbing capacity of UIOLI vs trapped mechanisms.*

Please see the technical analysis set out above in response to Question 6 to illustrate why AFME members consider that the Scalar of 0.8 for the UIOLI mechanism is unjustifiably high.

As set out in our response to Question 11, AFME members consider that the Alternative Approach currently being applied by the ECB is the correct approach to calculate the exposure value of SES for the purposes of Article 248(1)(e) of the CRR. Taking into the analysis set out in Section 5 of the Consultation Paper, this equates to a Scalar of approximately 0.4 under the Simplified Model Approach. AFME members consider that this is commensurate with the amount of losses historically observed on SRT synthetic securitisations.

Please also see our response to Question 2, above, in relation to the arbitrary nature of the Simplified Model Approach.

Q11. *Regarding the current supervisory practices on SES, described in paragraph 9 of the background section, the question is whether these practices could be adapted while keeping them aligned with the amended regulation, and the relative impact they would imply in comparison with the approaches included in the draft RTS. One way to try to further adapt the current supervisory practices on UIOLI SES to the provisions of the amended regulation could be by taking into account the part that is expected to cover for losses in the next period instead of the part that it is not, including at issuance of the transaction, keeping the rolling-window approach.*

Would you favour that approach? If so, how do you think that this rolling-window approach for calculating UIOLI SES will affect the efficiency and viability of synthetic transactions in comparison with the current supervisory practices? Please justify your response with specific illustrative examples or data.

AFME members acknowledge that the introduction of Articles 248(1)(e) and 256(6) of the CRR means that originators will now be required to treat SES as a retained tranche in a securitisation, and therefore will need to hold regulatory capital against that securitisation position by applying a risk-weighted amount of 1250% to the exposure value of that SES less any specific credit risk adjustments on the underlying securitised exposures.

However, in light of our General Observations, above, AFME members do not agree that the Level 1 text of Article 248 mandates that the exposure of the SES is calculated in accordance with either of the approaches set out in the Draft RTS.

The proper interpretation of Article 248(1)(e) of the CRR

The relevant part of Article 248(1)(e) reads as follows:

> *(e) the exposure value of a synthetic excess spread shall include, **as applicable**, the following:*
>
> *(i) any income from the securitised exposures already recognised by the originator institution in its income statement under the applicable accounting framework that the originator institution has contractually designated to the transaction as synthetic excess spread and that is still available to absorb losses;*
>
> *(ii) any synthetic excess spread that is contractually designated by the originator institution in any previous periods and that is still available to absorb losses;*
>
> *(iii) any synthetic excess spread that is contractually designated by the originator institution for the current period and that is still available to absorb losses;*
>
> *(iv) any synthetic excess spread contractually designated by the originator institution for future periods.*
>
> *For the purposes of this point, any amount that is provided as collateral or credit enhancement in relation to the synthetic securitisation and that is already subject to*

an own funds requirement in accordance with this Chapter shall not be included in the exposure value.'; (emphasis added)

This is supplemented by Article 248(4), which reads as follows:

> *4. EBA shall develop draft regulatory technical standards to specify how originator institutions are to determine the exposure value referred to in point (e) of paragraph 1,* ***taking into account the relevant losses expected to be covered by the synthetic excess spread****.* (emphasis added)

It is also useful to set out the text of Recital (11) to Regulation (EU) 2021/558, which sets out the EU legislators' rationale for requiring the originator to hold capital against SES as follows:

> *(11) Synthetic excess spread (SES) is a mechanism commonly used in the securitisation of certain asset classes* ***for originators*** *and investors to* ***reduce the cost of protection*** *and the exposure at risk, respectively. A dedicated prudential treatment of SES should be set out to* ***prevent SES from being used for regulatory arbitrage purposes****. In that context,* ***regulatory arbitrage occurs when an originator institution provides credit enhancement*** *to the securitisation positions held by protection providers* ***by contractually designating certain amounts to cover losses*** *of the securitised exposures during the life of the transaction,* ***and such amounts, which encumber the originator institution's income statement in a manner similar to an unfunded guarantee****, are not risk-weighted.* (emphasis added)

A number of points can be made about this Recital. First, it states that that the purpose of SES for the originator is to "reduce the cost of protection". Thus, this recognises that, as discussed in our responses above, the originator essentially has a choice between paying a higher coupon or committing an amount of SES to the transaction. However, while these two choices are aimed at a similar purpose, they are subject to very different treatment from a capital perspective. While the SRT assessment process does consider the cost of the protection (see, for example, the discussion in Section 3.2.6 and Recommendation 6 of the SRT Report), the purpose of doing so is to ensure that the cost of protection is not excessive in the context of the relevant securitisation (ie, taking into account the anticipated portfolio income and expected losses under various scenarios, as well as the originator's cost of capital), with a binary outcome being either to permit or disallow the recognition of SRT. Consistent with the fact that the prudential framework does not require banks to hold capital against liabilities, there is quite rightly no capital charge associated with the protection fees. However, when SES is being used for the very purpose of *reducing* the cost of protection, the originator is required to hold capital against the exposure value of that SES.

Secondly, Recital (11) also explicitly states that the purpose of the requirement to hold capital against SES is to "prevent SES from being used for regulatory arbitrage purposes". Regulatory arbitrage is usually understood to mean the practice of taking advantage of loopholes in regulatory systems in order to circumvent unfavourable regulations.[9] However, in the present case, Recital (11) provides its own definition of regulatory arbitrage, which it states "occurs when an originator institution provides credit enhancement … by contractually designating certain amounts to cover losses … which encumber the originator institution's income statement in a manner similar to an unfunded guarantee [and] are not risk-weighted". If this definition is applied literally, it would capture any amounts of

[9] See, eg, the explanation provided by Investopedia: https://www.investopedia.com/terms/r/regulatory-arbitrage.asp.

committed excess spread on the basis that the effect of that commitment is similar to an unfunded guarantee of the performance of the securitised exposures. However, perversely, that literal interpretation actually has precisely the opposite effect of the stated purpose of preventing regulatory arbitrage. This is because, as already explained in the previous paragraph, the originator essentially has a choice between paying a higher protection fee or committing SES. One of these options, SES, attracts a capital charge, but no such capital charge applies to the protection fee. Consequently, unless the calculation of the exposure value for SES takes into account similar factors as would apply to the assessment of the cost of protection, the originator is actually being incentivised to commit to paying a higher coupon so as to avoid the additional capital charge. This is despite the fact that SES is actually more efficient for the originator because, while a higher coupon will *definitely* encumber the originator's income statement over the life of the deal, SES committed to the securitisation will only encumber the originator's income statement to the extent that losses actually materialise in the relevant period. Thus, while an equivalent amount of "credit enhancement" (to adopt the language of Recital (11)) provided by way of SES is more favourable outcome for the originator, requiring the originator to hold capital against that SES actually incentivises the originator to adopt the less favourable outcome of paying a higher coupon.

Clearly it cannot have been the *intention* of the EU legislators that Article 248(1)(e) was being included in the capital rules to achieve precisely the opposite outcome of that stated in Recital (11) by incentivising an originator to adopt an approach which results in a greater encumbrance of its income statement. However, the foregoing analysis demonstrates why it also cannot be correct to adopt a literal reading of either the definition of "regulatory arbitrage" in Recital (11) or the text of Article 248(1)(e) of the CRR to determine the exposure value of SES. The point is not that applying *any* exposure value to future SES constitutes regulatory arbitrage. Rather, it is that applying *too much* SES, when measured against the other relevant metrics for the securitisation (such as the level of expected losses, the cost of the protection and the expected amortisation profile, etc.), is a form of regulatory arbitrage. Were such an excessive amount of SES to be instead converted into an increase in the protection fee, it would be expected to result in the originator being prevented from recognising SRT for the reasons discussed in Section 3.2.6 of the SRT Report (and thus rendering Article 248(1)(e) entirely inapplicable). Similarly, if that excessive SES was provided in the form of a retained first loss tranche, the associated capital charge for that first loss tranche would render the transaction uneconomic (or fail to satisfy the SRT tests). Thus, the regulatory arbitrage to be prevented is that of allowing an originator instead to provide that level of credit enhancement through SES so as to avoid the transaction being disallowed on the basis that the cost of protection or level of first loss retention was too high. However, it does not follow from this that *any* SES constitutes regulatory arbitrage, and to the extent that a literal reading of Recital (11) suggests otherwise, that literal reading must be disregarded for the reasons outlined above in favour of a more nuanced interpretation which focuses on determining where the amount of SES committed is excessive taking into account all the relevant circumstances of the securitisation.

Adopting such an approach is consistent with the jurisprudential approach of the European Court of Justice in interpreting EU legislation, in which provisions of EU law "must be interpreted in such a way as to guarantee that there is no conflict between it and the general scheme of which it is a part",[10] and that provisions of EU law must be interpreted "in harmony with the context in which [they] are placed".[11]

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[10] K Lenaerts and J A Gutiérrez-Fons, "To Say What the Law of the EU Is: Methods of Interpretation of the European Court of Justice", Academy of European Law Distinguished Lectures of the Academy (AEL 2013/9), page 14. See also page 26.

[11] Lenaerts, page 16.

During the negotiation of the Capital Markets Recovery Package (which ultimately incorporated new Articles 248(1)(e), 248(4) and 256(6) into the CRR) in late 2020, it was widely understood by (and indeed communicated to) the participants in the negotiations that these provisions *were not intended* to be interpreted as simply providing for the exposure value for SES for future periods to be equal to the product of the rate of SES or the rate of expected losses multiplied by the remaining maturity of the securitisation. Indeed, AFME members' understanding (based on discussions with the legislators at the time) is that the very purpose of the last minute insertion of the word "relevant" in Article 248(4) during the final round of the Trilogue negotiations (it was not contained in the initial draft of Article 248(1)(e) proposal from the Council (16 October 2020) or the European Parliament (10 November 2020)) was to ensure that there was sufficient flexibility in the level 1 text to allow the EBA to develop RTS which were appropriate in the context of the broader regulatory treatment of synthetic securitisation, and not to constrain the EBA into a rigid application of a literal reading of Article 248(1)(e)(iv), suggesting that the legislative intent was very much as outlined in the preceding paragraphs.

Before turning then to how the exposure value of SES should therefore be calculated in a manner which is consistent with both Recital (11) and the broader framework of the CRR, it is helpful to make some observations about the differences between SES and how excess spread works in a traditional securitisation.

The EBA rightly notes that synthetic excess spread works differently in the context of a synthetic SRT securitisation that it does for a traditional SRT securitisation, due to the fact that in a traditional securitisation all of the spread generated by the securitised exposures is necessarily transferred to the SSPE as an incident of the true sale, while in a synthetic securitisation that spread remains with the originator. Thus, in the case of a traditional securitisation, excess spread takes the form of *deductions* from the deferred income which is otherwise returned to the originator at the bottom of the securitisation waterfall to cover losses on the portfolio, whereas in a synthetic securitisation, synthetic excess spread is a form of loss absorption, by reducing the losses which are to be allocated to the tranches in the securitisation. However, AFME members disagree with the conclusions which the EBA draws from this difference in paragraph 8(ii) of the Consultation Paper (consistent with its views previously expressed in paragraph 119 of the SRT Report). The EBA appears to be concerned that SES works to encumber the originator's profit and loss account, which is not the case for excess spread in a traditional securitisation. While legally this is correct, that is most definitely *not* the case from an economic perspective. On the contrary, when properly calibrated, SES will have *no more* impact on the originator's P&L than excess spread in a traditional securitisation. Indeed, in a high loss scenario, unless the amount of SES committed is excessive, SES will actually have *less* impact on the originator's P&L, due to the SES being capped at an amount which is less than the amount of excess spread that would be available in that scenario in a traditional securitisation. Further, after adjusting for the impact of any difference in funding costs, where the excess spread is capped at the portfolio yield less funding and credit protection costs, the impact on the originator's P&L will be no worse than would have been the case prior to the securitisation. That is, the losses that are absorbed by the excess spread (whether in a traditional securitisation or a synthetic securitisation) would have been incurred even in the absence of the securitisation, and would therefore have impacted the originator's P&L. The only difference in practice is that whereas in a traditional securitisation the excess spread is, by definition, exactly equal to the portfolio income less the running costs and funding costs of the securitisation, in a synthetic securitisation, the SES is usually defined as a fixed percentage of the outstanding portfolio balance. However, so long as that fixed percentage is determined, taking into account the portfolio yield, expected losses and funding costs (ie, the cost of protection plus the cost of funding exposures remaining on the originator's balance sheet), the P&L outcome for the originator will be no worse than would be the case for a traditional securitisation of the same portfolio. Given that it is one of the basic principles of the capital framework that banks are *not* required to hold capital

against future income in the banking book, and that the P&L impact of SES is the same as the effect of excess spread in a traditional securitisation, there is no reason for treating SES differently from excess spread in a traditional securitisation, unless the rate of SES is excessive.

The EBA is usually at pains to apply the same regulatory treatment to synthetic securitisation as applies to traditional securitisation, unless there is a specific structural difference between the two types of securitisation which makes different treatment unavoidable. Even where that is the case, the different treatment should be kept to a minimum. One of the reasons for this is to avoid creating regulatory arbitrage between the two types of securitisation.

In the case of excess spread, AFME members acknowledge that the different legal structure of excess spread in traditional and synthetic securitisations does require some different rules for synthetic securitisations. However, as is the case with the differences in the structural requirements for achieving SRT set out in Articles 244(4) and 245(4) of the CRR, those differences should be aimed at achieving an equivalent economic outcome through the two different approaches, not to achieve a significantly different economic outcome for traditional securitisation compared with synthetic securitisation.

No specific rules are required to deal with excess spread in a traditional securitisation because, consistent with the EBA's observations, the excess spread is by definition only what is left after all funding and running costs for the securitisation have been deducted from the portfolio yield. In contrast, because SES is a commitment by the originator to the securitisation, rules are required to ensure that the amount of that commitment is not greater than the amount that would otherwise have been available to absorb those losses in a traditional securitisation.

In formulating those rules, the EBA must start from the fundamental premise outlined in above, that banks are not in the business of making losses. While there will always be defaults and losses on individual exposures, the expectation is always that such losses will be more than compensated for by the income generated by other exposures. Thus, while the capital rules quite rightly require banks to hold capital against unexpected losses which could occur at any time, and overwhelm the income generated by performing assets at *that* point in time, over the life of a loan portfolio, the probability that portfolio losses will exceed portfolio yield is exceedingly small. Therefore where, as is the very purpose of a SRT securitisation, the bank has transferred the risk associated with a portfolio to third parties, when considering the impact of various types of credit enhancement, it is important to distinguish between those forms of credit enhancement which will be offset by future income and those that will not, as follows:

- *Retained first loss tranche:* The essence of a first loss tranche is that an originator is exposed to losses, regardless of when they occur. If those losses are front-loaded, then they will be borne by the originator before it has had time to accrue the necessary income on the portfolio to offset those losses, which could therefore threaten the solvency of the originator. This therefore justifies the requirement for the originator to apply a 1250% risk-weight to that first loss tranche, or to deduct that tranche from capital.

- *High protection fee:* An originator expects to fund the protection fees paid in a synthetic securitisation out of the income generated by the securitised portfolio. Payment of these fees will therefore not impact on the solvency of the originator *unless* the cost of protection is so high that it cannot in fact be covered by the portfolio income. Even if that is the case, there may still be circumstances where paying such a high protection fee is appropriate (for example, to transfer the risk on an existing portfolio which has deteriorated since the time of origination). Accordingly, no capital charge is associated with the protection fee. Rather, where the protection fee is

excessive (taking into account all the relevant circumstances), the result is that the originator would simply be prevented from recognising SRT.

- *Synthetic Excess Spread:* SES falls somewhere between a retained first loss tranche and a high protection fee. However where, as is usually the case, it is calculated as a fixed percentage of the outstanding balance of the *performing* exposures, the appropriate analysis is closer to that which applies to the protection fee than that which applies to a retained first loss tranche. This is because the actual amount of SES that will be available in any given period will depend on which exposures are performing, and therefore yielding income, and in determining what amount of SES to commit to the securitisation the originator will have taken those income projections into account. Therefore, it is only where the amount of SES committed cannot be justified by reference to that expected income that the SES starts to behave more like a retained first loss tranche. AFME members view is, therefore, that this must be the starting point for determining the exposure value for SES for future periods under Article 248(1)(e)(iv) of the CRR.

One important difference between SES and excess spread in traditional securitisations is that excess spread in a traditional securitisation is by definition applied "ex-post" (ie, after the portfolio income has been received), whereas in most cases, SES is calculated by reference to the performing balance of the portfolio at the *beginning* of the relevant annual period, and thus will not be reduced by the income not received from exposures which default *during* that annual period. However, the impact of this distinction is limited to the current year. By the time the SES is being determined for the next year, those defaults will have been taken into account and reduced the amount of SES committed in that next year accordingly. Thus, while SES calculated ex-ante would justifiably be subject to a higher capital charge than SES calculated ex-post, the difference should be minimal, and this is already reflected in Article 248(1)(e)(iii) of the CRR, which already captures the full amount of remaining SES for the current year. Therefore, there is no reason to distinguish between SES calculated ex-ante and ex-post for the purposes of Article 248(1)(e)(iv) of the CRR.

The principles summarised above can be reflected in regulatory standards in various ways, with increasing levels of complexity. We set out below two possible approaches, both of which we consider are consistent with the level 1 text of Article 248(1)(e). However, taking into account the reality that there is *no evidence* that SES has or is currently being used in the EU for regulatory arbitrage, in the interests of avoiding imposing an unnecessarily complex burden on originators, and to avoid the risk that complicated modelling requirements will produce anomalous outcomes for individual transactions, AFME members strongly urge the EBA to adopt the simplest approach set out below as the "Preferred Approach". This could be coupled with a requirement that the originator be required to demonstrate as part of the SRT assessment process that the amount of SES committed is justified taking into account all relevant circumstances of the securitisation, but without prescribing mechanistic tests to achieve this. This approach would meet the objectives outlined in Recital (11) far more effectively than adopting a complex modelling approach such as that proposed in the Draft RTS.

Preferred Approach

Returning to the text of Articles 248(1)(e) and (4) of the CRR, AFME members note that Article 248(1)(e)(iv) does not specify *which* future periods should be taken into account. In particular, it does *not* state that this should be a reference to *all* future periods. In addition, the introductory text of Article 248(1)(e) refers to the exposure value as including the amounts referred to in limbs (i) to (iv) "as applicable". In the case of limb (iv), this reference to "as applicable" should be read as a cross-reference to those periods which the EBA has determined to be relevant for the purposes of the RTS under Article 248(4).

As discussed in our General Observations, above, the capital framework in the CRR is based on taking into account expected losses over a one-year time horizon. For example, for unsecuritised exposures, current losses are deducted from capital under Article 36(1)(a) of the CRR and, for institutions applying the IRB Approach, any excess of one-year EL over the credit risk adjustments associated with those exposures, is also deducted from capital under Articles 36(1)(d) and 159 of the CRR. Further, institutions are not required to hold capital against future income. Taking these two basic principles of the capital framework as the starting point, it is therefore entirely appropriate to treat the reference to "future periods" as a reference to the forthcoming 1-year period from the date of calculation. Further, because losses already realised and current impairments will have already been deducted from capital under Article 36(1)(a) of the CRR, it makes no sense to hold capital against those amounts again.[12] Thus, the exposure value for the SES for future periods is the amount of SES for the forthcoming 12-month period, less any realised losses and impairments which have already been applied to against that available SES. This is, of course, exactly the approach which the ECB has been applying, and referred to as the "Alternative Approach" in the Consultation Paper.

This approach is also consistent with the requirement to include in the exposure value of SES amounts of SES from the current and previous periods which are still available to absorb losses in Articles 248(1)(e)(ii) and (iii) of the CRR or amounts of income already recognised by the originator in its income statement but which is available to absorb losses under Article 248(1)(i) of the CRR. This is because the above approach for future periods rests on the fundamental principle, consistent with the entire capital framework of the CRR, that institutions *are not* required to hold capital against *future unearned* income. However, in the case of SES from a previous period which is still available to cover future losses, or amounts which have previously been recognised as income by the originator but are still available to cover future losses, those commitments will directly encumber the originator's P&L account should those losses eventuate.

This approach also avoids the incentivising originators to commit an amount of SES which is greater than the expected losses in the matter discussed in our response to Question 6, above, as such excess will simply increase the exposure value of the SES, and thus the resulting capital charge. By keeping the exposure value of the future SES relatively low, it also avoids incentivising the originator from paying a higher coupon in lieu of SES as discussed above in relation to the interpretation of Recital (11).

For these reasons, AFME members strongly support maintaining the *existing* Alternative Approach applied by the ECB, whereby the originator is required to capitalise the 1-year SES net of realised losses and specific credit risk adjustments on a rolling 1-year basis. Indeed, we are of the view that this is the *only* way in the exposure value for SES for future periods can be calculated in a way which is both consistent with the broader capital framework and avoids producing an exposure value which is so large as to render the use of SES uneconomic in virtually all transactions.

Fallback Approach

A more complicated approach would be for the RTS to set out a method for determining when the amount of SES committed for future periods is excessive by reference to the expected yield and losses on of the securitised portfolio for each future period in a way which replicates how excess spread would apply in a traditional securitisation. The exposure value for of the SES for those future periods would therefore be the sum of the amount by which the amount of SES for each future period during

[12] We note that it was agreed in the 1st political trilogue discussion on 19 November 2020 that there should be no double-counting of capital requirements in relation to SES.

the expected maturity of the transaction exceeds the amount of excess spread which would have been available in a traditional securitisation of the securitised portfolio having the same capital structure.

Returning to the text of Articles 248(1)(e) and (4) of the CRR, this would mean interpreting the reference to the excess spread designated for future periods, coupled with the reference to "relevant losses" to be covered by that SES should be read as a reference to the *net losses*, determined after taking into account the income to be generated by the securitised exposures over the same periods. For this purpose, the portfolio income should be reduced by the cost of protection, as well as by an implied protection spread for any retained positions in the securitisation which are not assigned a 1250% risk-weight or otherwise deducted from capital. Because the senior tranche(s) of a synthetic securitisation are *always* retained by the originator, this implied protection spread cannot be determined by reference to a market test along the lines set out for traditional securitisations in paragraph 125 of the SRT Report. Rather, it should be possible for the originator to extrapolate an appropriate protection spread for those retained tranche(s) by reference to the spread for the protected tranche(s) and the relative risk associated with those retained tranche(s).

Thus, where the amount of SES designated for future periods is less than the remaining portfolio income, the exposure value of the SES for that future period would be zero. However, where the originator contributes an amount of SES which is greater than that remaining portfolio income (and which would have been impossible in a traditional securitisation), that excess would be captured as the exposure value for that future period.

This approach is entirely consistent with the Alternative Approach currently applied by the ECB, as discussed in paragraphs 10 and 11 of the Consultation Paper, as well as with the requirement to include in the exposure value of SES amounts of SES from the current and previous periods which is still available to absorb losses in Articles 248(1)(e)(ii) and (iii) of the CRR or amounts of income already recognised by the originator in its income statement but which is available to absorb losses under Article 248(1)(i) of the CRR for the same reasons as outlined above in relation to Approach 1.

We understand that the EBA has, at various times in the past, expressed the view that attempting to replicate the economics of traditional securitisation excess spread in order to determine the appropriate exposure value for synthetic excess spread is too complex. This is simply not the case. The same systems which banks use to capture the relevant data points for traditional securitisations can be used to make the equivalent calculations for synthetic securitisations. Further, as noted above, given that all SRT transactions must go through the SRT assessment process, there is ample opportunity for a bank's supervisor to disallow recognition of SRT if it is not satisfied with the modelling and calculations which the bank has undertaken in relation to its use of SES. Put simply, an incorrect assumption that applying the same approach to SES as applies to excess spread in traditional securitisation is no basis for requiring all banks to adopt a "lowest common denominator" approach. In addition, in AFME members' view, the Full Model Approach proposed in the Draft RTS itself requires modelling that is no less complex than that required to replicate the effect of traditional securitisation excess spread. Finally on this point, we note that even if the EBA was correct — which it is not — that it is too complex to follow the traditional securitisation approach, that does not justify an approach which is based on a completely different conceptual foundation from that which applies to the treatment of excess spread in traditional securitisation, particularly when to do so involves requiring banks to hold capital against future income in a manner totally at odds with the entire foundation of the capital framework. Rather, the appropriate regulatory response is to devise a way of correctly approximating the effect of excess spread in traditional securitisation. In our view, the Alternative Approach discussed above (ie, AFME members' "Preferred Approach") is a proportionate and reasonable answer to that challenge.

Q12. *Do you agree with the treatment of the ex-post SES of future periods in the RTS? If not, please provide rationale and data supporting your views.*

Please see our General Observations and response to Question 11, above.

Q13. *Do you have any other comments on these draft RTS?*

AFME members have a number of additional comments on the Draft RTS.

Grandfathering and Phase-in

The Draft RTS contain no provision for grandfathering of existing securitisations, or for the phase-in of the new rules.

AFME members note that the level 1 text of Article 248(1)(e) does not contain any provision for grandfathering, while Article 2 of Regulation (EU) 2021/558, which inserted sub-paragraph (e) into Article 248(1) of the CRR, merely states that that amendments should apply from 10 April 2022. Nevertheless, AFME members consider that both grandfathering of existing securitisations, and a phase-in period before the new rules apply to new securitisations is appropriate for the following reasons.

As the EBA itself notes in paragraphs 9–11 of the Consultation Paper, the approach outlined in the Draft RTS is very different from the approach which has been applied by the ECB for several years, including following the passing of Regulation (EU) 2021/558. Thus, many synthetic securitisations have been structured and executed in compliance with that ECB approach, leading to a legitimate expectation on the part of originators that this was the correct approach to apply. This situation has been exacerbated by the fact that the EBA was required by Article 248(4) of the CRR Article 1(2)(b) of Regulation (EU) 2021/558 to have submitted the RTS for calculating the exposure value of SES to the European Commission by 10 October 2021, whereas the Consultation Paper was in fact only published on 9 August 2022, without the EBA having provided any indication in the intervening period of its proposed approach to this issue. We note that, due to what appears to be an error in the text of Article 2 of Regulation (EU) 2021/558, technically the EBA's mandate under Article 248(4) of the CRR did not exist until 10 April 2022 (ie, six months *after* the RTS were supposed to have been submitted to the Commission), but it is neither reasonable nor appropriate to expect originators which have complied with the requirements of their competent authority to be subject to a differential capital treatment of their securitisations, particularly where that partly stems from a failure by the EU legislators to draft the implementing legislation properly in the first place such that it was impossible for the rules to be place in time.
Even if the EBA takes the view that grandfathering is not permitted by the level 1 text, Recital (12) to the Regulation (EU) 2021/558 explicitly states that "institutions should be given sufficient time to apply the new prudential treatment of SES". Together with the statement in that same recital that the "regulatory technical standards should be in place before the new prudential treatment becomes applicable" (which was on 10 April 2022), it is self-evident that there should be a phase-in period, such that existing securitisations should only be required to apply with the new rules from a future date. AFME members therefore propose that the RTS should provide that the new rules will not apply to securitisations which are outstanding on the date on which the RTS enter into force until 1 January 2025.

Without a phase-in period like this, many existing synthetic securitisations will immediately become uneconomic. Whether or not this results in originators exercising regulatory calls to unwind these transactions, the immediate effect will be a dramatic increase in the amount of capital required to be held by banks. Given that synthetic excess spread has been more commonly used by banks with a less robust capital position in the first place, imposing such a significant increase in capital requirements will have a very significant impact on those institutions ability to continue providing financing to the real economy. Even if the originator is able to exercise a regulatory call to terminate a securitisation which is no longer economically viable, that would be a very unwelcome development, having the effect of immediately requiring originators to hold significantly higher amounts of capital than is the currently the case, even though, as discussed in our General Observations there is no evidence that such transactions have been motivated by inappropriate behaviour or regulatory arbitrage.

Consistent with the statement in Recital (12) quoted above, AFME members also propose that the new RTS should not enter into force until a date falling at least six months after their publication in the Official Journal. This would be consistent with the original expectation that the RTS would be finalised by 10 October 2021 before Article 248(1)(e) entered into effect from 10 April 2022. Given the significant change which the Draft RTS entail to the existing treatment of synthetic excess spread, and the implications which this will have for the significant risk transfer and commensurate risk transfer tests under Article 245(2) of the CRR, coupled with the lengthy execution time for most synthetic securitisations (taking into account the requirement for advance notification to be made to competent authorities), it is appropriate that institutions are given sufficient time to adjust to the new requirements before being required to comply.

Exposure value of SES for current period (Article 248(1)(a)(iii))

The Draft RTS provide for the Full Model Approach or Simplified Model Approach to apply only to the calculation of the exposure value of the SES for future periods under Article 248(1)(a)(iv). It is not clear to AFME members why these approaches are not also to be used to calculate the value of the SES for the *current* period. While we note the different wording used in limbs (iii) and (iv) of Article 248(1)(a) (limb (iii) refers to the amount of SES contractually designed for the current period "that is still available to absorb losses", while limb (iv) simply refers to the amount of SES contractually designed "for future periods", we do not think that there is any real difference in the meaning of the two limbs. Article 248(4) requires the RTS to specify how the exposure value is to be determined for the whole of Article 248(1)(e) "taking into account the relevant losses expected to be covered by the synthetic excess spread". It does not limit the relevance of the losses expected to be covered to the SES for future periods. AFME member are therefore of the view that it would be entirely consistent with the level 1 text for the modelling approaches to apply to the value required to be recognised for the SES for the current period as for the future periods, even if this would have only a relatively minor impact on the overall exposure value of SES.

Deduction of Specific Credit Risk Adjustments

In Section 5 of the Consultation Paper, the EBA makes the observation in a number of places that one effect of the requirement to treat the exposure value of SES as a tranche in the securitisation is that the originator would now be permitted to deduct the specific credit risk adjustments for the underlying exposures from the exposure value of the SES under Article 248(1)(d), rather than from the exposure value of the first loss tranche as was previously the case. While this is correct, it should be clarified that where the amount of those SCRAs is greater than the exposure value of the SES, the originator would still be permitted to deduct that excess from the exposure value of the first loss tranche.

Relationship between RTS and EBA Report on SRT

The EBA's SRT Report contained a precursor proposal by the EBA for the exposure value of synthetic excess spread ("**EEVES**") to be treated as a retained position in a synthetic securitisation, and therefore a requirement for capital to be held against that EEVES (see paragraph 216 of the EBA Report), which it acknowledged would require a change to the level 1 text of the CRR. At the same time, in the SRT Report, the EBA provided for the EEVES to be taken into account in the calculation of tests for significant risk transfer and commensurate risk transfer, on the basis that the EEVES was effectively risk retained by the originator and not transferred to investors for the purposes of that analysis.

The amendment introduced into the CRR in Article 248(1)(e) goes some way to implementing the EBA's proposal. What is unclear, however, is how the EBA sees the relationship between the exposure value of SES for the purposes of Article 248(1)(e) and the EEVES for the purpose of the SRT/CRT tests set out in the SRT Report. At the Public Hearing on 6 September 2022, the EBA made some ad hoc observations that it would expect some consistency between the exposure value of SES calculated pursuant to Article 248(1)(e) and the EEVES. However, this cannot really be the case. As set out in the SRT Report, the EEVES refers to the amount of both expected losses and unexpected losses which are expected to be borne by excess spread. In contrast, the Full Model Approach only requires that it is the expected losses which need to be taken into account in calculating the exposure value of the SES for the purposes of Article 248(1)(e).

Given the close relationship between the SRT/CRT tests and the capital requirements for retained securitisation positions, it is essential that the EBA refreshes its views on how excess spread should be treated for the purposes of those tests. In particular, should the EEVES now be understood to be equal to the exposure value of the SES for the purposes of Article 248(1)(e)? Or should the EEVES be understood as the sum of the exposure value of the exposure value of the SES for the purposes of Article 248(1)(e) and the unexpected losses for the securitisation? Certainly it should not be the case that the EEVES should use a different method for determining the expected losses component of EEVES from that used for the purposes of Article 248(1)(e).

While AFME members appreciate that EBA's mandate under Article 1(2)(b) of Regulation (EU) 2021/558 only relates to Article 248(1)(e), and does not relate to the requirements for significant risk transfer more generally, the lack of clarity as to how the different parts of the regulations and regulatory guidance fit to together creates enormous uncertainty for the market. Accordingly, AFME members request that the EBA takes the opportunity to update or clarify its guidance on significant risk transfer in parallel with the finalisation of these RTS.

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Example (Question 2)

	0.5	1.5	2.5	3.5	4.5	5.5	
	30/06/2022	*30/06/2023*	*30/06/2020*	*30/06/2021*	*30/06/2022*	*30/06/2023*	
Assumptions						**Assumed time call**	
w.a. PD	4.00%						
w.a. LGD	40.0%						
Expected Loss	1.60%						
Excess Spread	1.00%						
WAL	3.62	2.62	1.62	1.26	0.95	0.50	
Scalar	0.80						
Portfolio							
BoP	2,000.0	2,000.0	2,000.0	1,450.0	1,000.0	725.0	500.0
Amortisation	-	-	-550.0	-450.0	-275.0	-225.0	
EoP	2,000.0	2,000.0	1,450.0	1,000.0	725.0	500.0	
Losses	32.0	32.0	27.6	19.6	13.8	9.8	
Excess spread available							
BoP	20.0	20.0	20.0	14.5	10.0	7.3	5.0
Credit Losses							**Total**
Evenly-loss	32.0	32.0	27.6	19.6	13.8	9.8	*134.8*
Front-loaded loss	44.9	44.9	11.2	11.2	11.2	11.2	*134.8*
Back-loaded loss	11.2	11.2	11.2	11.2	44.9	44.9	*134.8*
Excess spread absorbing losses							
Evenly-loss	20.0	20.0	20.0	14.5	10.0	7.3	91.8
Front-loaded loss	20.0	20.0	11.2	11.2	10.0	7.3	79.7
Back-loaded loss	11.2	11.2	11.2	11.2	10.0	7.3	62.2
							77.9
Simplified method							
Exposure value	*57.9*						
Exposure Value Excess Spread through time							
Full Model Approach	*77.9*	*60.8*	*43.7*	*29.6*	*17.3*	*7.3*	
Simplified Model Approach	*57.9*	*41.9*	*18.8*	*10.1*	*5.5*	*2.0*	

Front-loaded	*Losses*	*Timing*	*Allocatie*
2/3 losses in first 1/3	89.9	2.0	44.9
1/3 losses in last 2/3	44.9	4.0	11.2
Back-loaded			
1/3 losses in first 2/3	44.9	4.0	11.2
2/3 losses in last 1/3	89.9	2.0	44.9

Appendix: Mathematical Model

The following model applies to the technical analysis set out in our response to Question 6, above.

For simplicity we construct a mathematical model of portfolio loan behaviour based on the following assumptions:

i. All loans in the portfolio have the same term and are bullets
ii. All loans in the portfolio have the same annual expected loss and this does not vary over the term
iii. All loans in the portfolio have the same LGD

The following notation is used:

Loan Term (in years)	T
Loan LGD	Λ
Loan Annual EL	$\mathcal{E}$

Additionally, we define the following:

1y PD	$p := \mathcal{E}/\Lambda$
1y Shape Parameter	k
Scale Parameter	$\theta := (1-p)^{-\frac{1}{k}} - 1$
Random variable for 1y realised defaults	G
Random variable for lifetime defaults	H
UIOLI SES	$s := \mathcal{E}$
Random variable for utilised SES in a year	U
Random variable for lifetime utilised SES	V

We model the annual defaults on the portfolio as being based on a gamma distribution[13]; in particular, we take Y to be a gamma distributed random variable with parameters k and θ, so that:

$$\Gamma(y; k, \theta) := \mathbb{P}(Y < y) = \int_0^y \frac{x^{k-1} e^{-\frac{x}{\theta}}}{\Gamma(k)\theta^k} dx$$

We than take the annual realised defaults to be G calculated as:

$$G := 1 - e^{-Y}$$

To calibrate the values of the parameters k and θ, we note that we seek the expected value of G to be equal to the annual PD, P, so that:

$$\mathbb{E}(G) = 1 - \mathbb{E}(e^{-Y}) = p$$

The moment generating function of the gamma distribution is known, so that

[13] The gamma distribution provides for a range of shapes of distribution that reasonably well represent the performance of a portfolio under a wide range of correlation assumptions, the impact of correlation being the dominant factor that prevents the central limit theorem applying in credit context and causing realised losses to be tightly clustered around expected losses.

$$\mathbb{E}(e^{tY}) = (1 - t\theta)^{-k}$$

and therefore,

$$\mathbb{E}(G) = 1 - (1 + \theta)^{-k} = p$$

which gives, as indicated above,

$$\theta = (1 - p)^{-\frac{1}{k}} - 1$$

The variance of G can be calculated as follows:

$$\text{Var}(G) = \text{Var}(1 - G) = \mathbb{E}(e^{-2Y}) - \mathbb{E}(e^{-Y})^2$$

$$= (1 + 2\theta)^{-k} - (1 + \theta)^{-2k}$$

This is a decreasing function of k so that as k increases, the variance, and hence standard deviation of G decreases.

The one year losses on the portfolio can be represented by $G\Lambda$ and it can be seen that the expected value of this is equal to $p\Lambda = \mathcal{E}$.

Suppose the portfolio has balance B at the start of a year; then in that year, the utilisation of SES will be:

$$U = \text{MIN}(\Lambda G, s) = \Lambda\, \text{MIN}(G, \mathcal{E}/\Lambda) = \Lambda\, \text{MIN}(G, p)$$

So that the expected utilisation of SES will be:

$$\mathbb{E}(U) = \Lambda\, \mathbb{E}\big(\text{MIN}(G, p)\big)$$

$$\mathbb{E}\big(\text{MIN}(G, p)\big) = \int_{G=0}^{G=p} G\, dG + p \int_{G=p}^{G=1} dG$$

$$= \int_{G=0}^{G=p} G\, dG + p\left(1 - \int_{G=0}^{G=p} dG\right)$$

To calculate this, we need to change variables from G to Y:

$$G = 1 - e^{-Y}, Y = -\log(1 - G)$$

So we get,

$$\mathbb{E}\big(\text{MIN}(G, p)\big) = \int_0^{-\log(1-p)} (1 - e^{-Y}) dY + p\left(1 - \int_0^{-\log(1-p)} dY\right)$$

$$= p + (1 - p) \int_0^{-\log(1-p)} dY - \int_0^{-\log(1-p)} dY$$

It can be calculated that

$$\int_0^y e^{tY} dY = (1 - t\theta)^{-k}\, \Gamma\left(y; k, \frac{\theta}{1 - t\theta}\right)$$

So that,

$$\mathbb{E}\big(\text{MIN}(G, p)\big) = p + (1 - p)\Gamma(-\log(1 - p)\,; k, \theta) - (1 + \theta)^{-k}\, \Gamma\left(-\log(1 - p)\,; k, \frac{\theta}{1+\theta}\right)$$

This can be inserted to provides a closed form computation of the expected utilisation of 1y SES, U, but since expectation is linear and each year's performance is assumed to be independent, we can also use this to provide a closed form expression for V by multiplying this by the expected annual balances, taking into account the expected prior defaults.

Since we are assuming that the loans are non-amortising, it is also possible to determine the distribution of the lifetime defaults and lifetime losses.

The non-defaulted proportion of the portfolio after 1y is given by $1 - G$, and hence after T years, by $\prod_1^T (1 - G_i)$, where the index i references the years of the transaction. Therefore, the lifetime defaults H are given by,

$$H = 1 - \prod_1^T (1 - G_i) = 1 - \prod_1^T e^{-Y_i} = 1 - e^{-\sum_1^T Y_i}$$

Then the expected lifetime defaults are given by:

$$\mathbb{E}(H) = 1 - \mathbb{E}(e^{-Y})^T = 1 - (1 + \theta)^{-Tk} = 1 - (1 - p)^T$$

The gamma distribution has the property that if Y_i are independent, identical and each gamma distributed so that,

$$\mathbb{P}(Y_i < y) = \Gamma(y; k, \theta)$$

Then the sum, $Z = \sum_1^N Y_i$ is also gamma distributed with

$$\mathbb{P}(Z < z) = \Gamma(z; kN, \theta)$$

Therefore, we see that $-\log(1 - H) = \sum_1^N Y_i$ is also gamma distributed, and hence can write

$$H = 1 - e^{-Z}$$

This makes it easy to determine quantiles of the distribution of H from those of the gamma distributed random variable Z.

Note also that, in addition to these closed form mathematical formulations, all of these calculations can also be carried out using Monte Carlo simulations of the relevant random variables and distributions, yielding similar results.

Technical References

[1] “Gamma process dynamic modelling of credit”, Baxter, 2007 – Gamma Process applied to credit derivatives

[2] “Financial Modelling with Jump Processes”, Cont & Tankov, – mathematical background to Gamma Processes

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[4] “Intensity Gamma: A New Approach to Pricing Portfolio Credit Derivatives”, Joshi & Stacey, 2006 – Gamma Process applied to credit derivatives

[5] “More Mathematical Finance”, Joshi, 2011 (Section 10.5) – Gamma Processes applied to credit derivatives

[6] “Foundations of the Proposed Modified Supervisory Formula Approach”, BCBS, 2013