Supervisory Statement | LSS9/13

Securitisations: high cost credit protection in synthetic transactions

April 2013

BANK OF ENGLAND
PRUDENTIAL REGULATION
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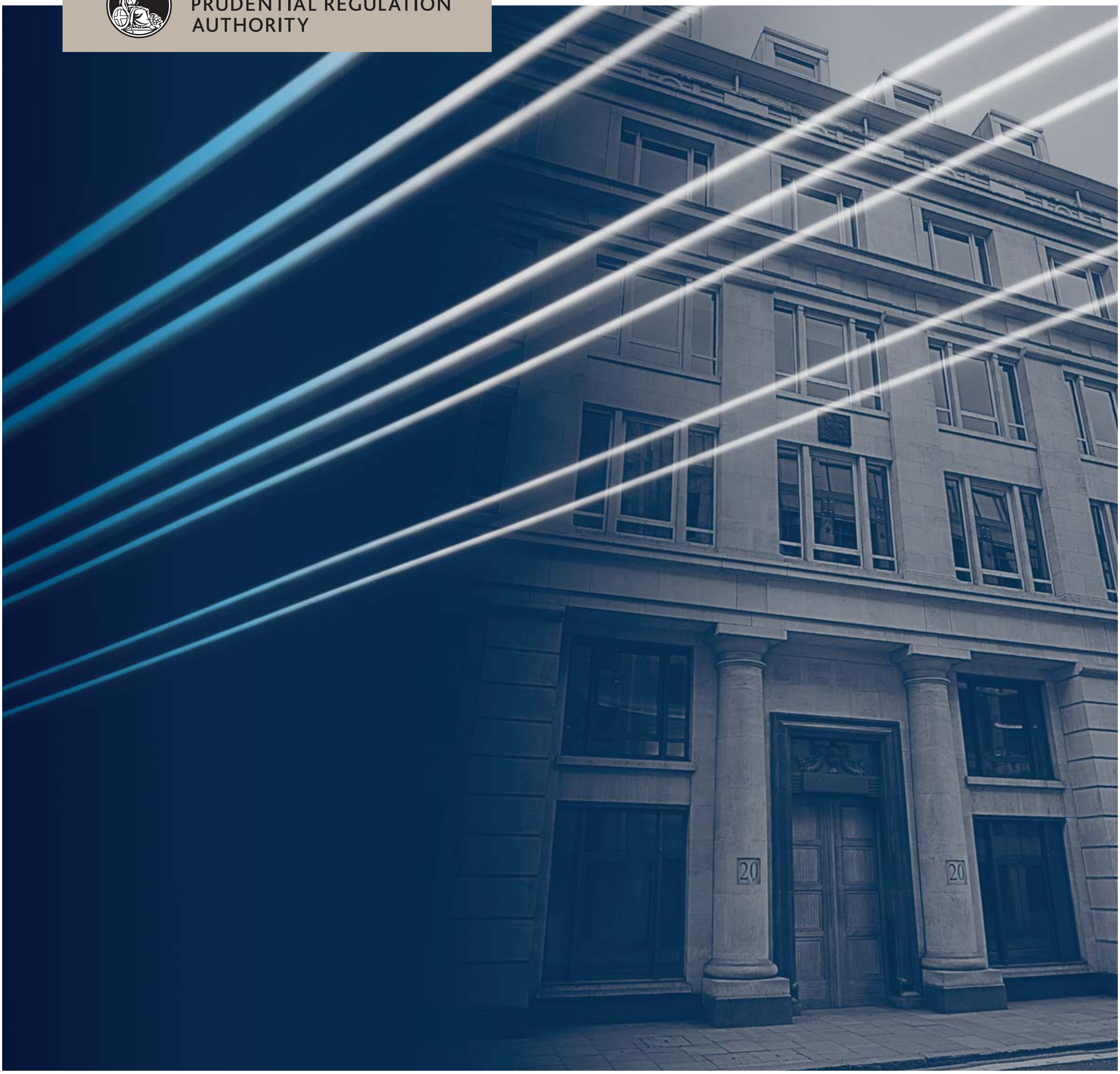

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From its commencement on 1 April 2013, the Prudential Regulation Authority (PRA) has adopted a number of legacy FSA policy publications relevant to the advancement of its objectives. This document, initially issued by the FSA in the form of three separate letters to the industry, has been adopted by the PRA as a Supervisory Statement as part of this process. The PRA may choose to review this legacy publication at a later stage.

The FSA published guidance to UK banks in July 2009 in respect of certain synthetic securitisation transactions frequently known as 'tranche protection trades' or 'high cost credit protection transactions'. This communication (which is summarised in Section 1 below) resulted in the publication of two additional letters to the industry between 2009 and 2010. The key elements of these additional letters are summarised in Section 2 of this document.

1 Synthetic securitisation transactions

This section highlights our views regarding the use of synthetic securitisation transactions to reduce capital requirements.

In particular, it addresses protection arrangements where unfunded protection is purchased on a junior tranche. However, the principles outlined in this letter apply to all types of protection arrangements (ie both funded and unfunded synthetic; and all tranches). In certain market conditions, external capital raising can be prohibitively expensive, and there can be a desire by some firms to seek ways to manage regulatory capital requirements by reducing risk positions. In the current market conditions, outright asset sales might not deliver value and so it is natural to look at credit protection contracts as a mechanism to achieve a transfer of risk.

The rules determining whether a credit protection arrangement will have the effect of reducing minimum capital requirements are set out in BIPRU. A number of potential transactions have been created that use tranched credit protection, which would be considered a synthetic securitisation and therefore covered by BIPRU 9. A key principle of BIPRU 9 is that reductions in regulatory capital requirements should only occur when there is a transfer of significant risk, away from the originator of the assets, to a third party.

However, there have been transactions where there is little or no transfer of economic risk from the protection buyer to the protection seller. A particular example of a transaction-type of concern involves protection being purchased on a junior tranche accompanied by a high premium. These protection arrangements seemingly transfer the benefit of the protection if the covered assets do not perform.

In typical transactions, the premium paid will not materially affect the assessment of whether significant risk transfer has occurred. This is because either:

- the protection payment payable upon default from protection seller to protection buyer will dwarf the overall premium payable to the protection seller; or
- the premium is payable up front and leads to an immediate incurred cost.

However, there comes a point at which the premium payable for the protection can have a significant detrimental effect on the actual economic risk that is transferred from the protection buyer to protection seller. In extremis, a premium payable of 100% of the protection amount, or more, can put the protection buyer in no better position over the life of the transaction than if it did not purchase the protection at all.

In the current environment, when the future performance of loan receivables is so uncertain, premiums payable for credit protection can be extreme. It is important that the senior management of firms are fully engaged in the execution of transactions that lead to a reduction in required capital (both providers and purchasers of structured trades), and that the purchasers of such products ensure that all factors, including high premiums, are adequately reflected when assessing any transfer of risk. This will ensure that these trades comply with the letter and the spirit of the BIPRU framework, and will not result in less regulatory capital being held against positions than is warranted by the economic risk that remains with the protection buyer. When risk transfer transactions are structured as a group of linked transactions rather than a single transaction, the aggregate effect of linked transactions must comply with the letter and the spirit of the BIPRU framework, and particular care must be exercised to ensure that the analysis incorporates all linked transactions, particularly if certain transactions within a group of linked transactions are at off-market rates.

The size of some transactions can be material and therefore we expect, under Principle 11, providers and purchasers of regulatory capital structures to discuss them with their usual supervisory contacts prior to executing such trades.

2 Further detail on tranche protection trades

This section provides further clarification on the above section and the PRA policy on the capital treatment of synthetic securitisations and other similar protection schemes, including (but not limited to) the transactions referred to in Section 1. Note that this section is neither a reinterpretation of BIPRU 9 nor a change in policy.

A. Objectives of the current regulatory framework

Any reduction in capital requirements achieved through securitisation should be matched with a commensurate transfer of risk to third parties. BIPRU 9.3.9G sets out that where we decide that the possible reduction in risk-weighted exposure amounts which would be achieved through securitisation is not matched by such commensurate transfer of risk, we will use our powers under section 55J of FSMA to require the firm to increase its risk weighted exposure amounts to an amount commensurate with our assessment of the transfer of credit risk to third parties.

Further, we expect firms to apply a substance over form approach when assessing Significant Risk Transfer (SRT). This principle applies to all securitisations and is reflected in BIPRU 9.1.5G, which states that 'since transactions may be structured in many different ways, the capital treatment of a position should be determined on the basis of its economic substance rather than merely its legal form'. Therefore, firms must be able to demonstrate that the capital relief post-transaction adequately captures the economic substance of the entire transaction and is appropriate compared to the retained risks.

This overarching principle also applies to the assessment of the minimum requirements contained in BIPRU 9.5.1R. In particular, the instruments used to transfer credit risk must not contain any terms or conditions which materially reduce, mitigate or otherwise limit the amount of risk transferred. The terms and conditions in BIPRU 9.5.1R (4) do not constitute an exhaustive list and firms should consider all transaction features which implicitly or explicitly produce a similar economic outcome. For example, where losses or defaults occur in the pool (ie deterioration in the credit quality of the underlying pool) the originator's net cost of protection or the yield payable to investors should not increase.

B. Regulatory capital assessment: impact of premiums

Originators seeking to apply BIPRU 9 to their synthetic securitisations must take into account all relevant factors to assess the amount of risk transferred (if any). Indeed, as per BIPRU 9.1.5G, 'the capital treatment of a position should be determined on the basis of its economic substance rather than merely its legal form'. As well as the size and timing of amounts payable to the protection seller, the circumstances in which those amounts are payable can undermine the effectiveness of risk transfer. All of these factors are therefore very important to a firm's assessment of risk transfer and of any resulting regulatory capital reduction. We expect firms seeking capital relief through synthetic securitisations to incorporate premiums in their assessment of SRT. In particular, the following examples of transaction features may have a significant impact on the amount of risk transfer and should therefore be incorporated in any firm assessment:

- premium which is guaranteed in all or almost all circumstances, for example premium which is payable upfront or deferred;
- where the amount of premium payable for protection could be significantly greater than the spread income on the assets in the portfolio or similar to the size of the hedged position; or
- where the protection buyer retains the expected loss through higher transaction costs to the counterparty, whether in the form of premium or otherwise.

Where a transaction has no explicit tranching, but the terms (eg guaranteed premium) economically result in there being an implicit retained position or economic tranching, the transaction should be treated as a securitisation under BIPRU 9.

C. Incentives for the protection buyer to call the transaction

In addition to the issue of premiums, a second key area which firms must assess in analysing SRT is BIPRU 5.8.4R which determines the effective maturity of any credit risk mitigation, including synthetic securitisations, where an option to terminate the protection exists at the discretion of the protection buyer. It states that 'where the terms of the arrangement at origination of the protection contain a positive incentive for the firm to call the transaction before contractual maturity, the maturity of the protection must be taken to be the time to the earliest date at which that option may be exercised'.

The following are examples of features which will normally indicate a positive incentive to call or, at least, constitute grounds for further discussion with us prior to the conclusion of the transaction:

- the transaction contains terms, such as payments at maturity or payments upon early termination or significant premiums, which may reduce risk transfer;
- the transaction includes a requirement for the protection buyer to incur additional costs or obligations if they do not exercise their option to terminate the protection; and
- there are pre-agreed mechanisms, for example 'at-market unwinds', where the protection seller and protection buyer agree that the transaction can be terminated in the future at a 'market' value and specifies aspects of how the value is calculated.

D. Application to similar transactions, reporting and disclosure

While the main purpose of this section is to provide further clarification on the PRA's policy on the capital treatment of synthetic securitisations, the policies and principles are also applicable to any securitisation transaction subject to BIPRU 9, as well as to other similar credit protection arrangements. This is consistent with the policy objective that the securitisation framework is not used to undermine or arbitrage other parts of the prudential framework.

In relation to other similar credit protection arrangements, for example those subject BIPRU 5, BIPRU 4.10 (credit risk mitigation)[1] or BIPRU 7 (trading book), firms should be aware that the impact of certain features (for example, significant premiums or call options) may cast doubt on the extent of risk transferred and the resulting capital assessment. Features which result in inadequate capital requirements compared to the risks a firm is running may result in the credit protection not being recognised or the firm being subject to extra capital charges in their Individual Capital Guidance (ICG) in the form of Pillar 2 add-ons in line with BIPRU 2.2.16G to 2.2.19G. Firms should not seek to arbitrage standards by deliberately structuring transactions so that they fall into a specific section of the Handbook.

Although claiming capital relief for certain securitisation transactions is notifiable under BIPRU 9.3.8, firms are reminded that, under Principle 11, they should discuss any securitisations, or other credit protection arrangements which are material or have complex features with their usual supervisory contacts. If firms have reason to believe that we may have an interest in understanding a transaction, this should be disclosed to us prior to completion. Firms should also disclose to the PRA any existing transaction with such features.

Firms should approach us at an early stage, as this may prevent an unnecessary expenditure of time and resources. If a firm chooses not to do so prior to completion, it should not claim any regulatory capital reduction from these transactions in its disclosures to the market without warning of the risk of full or partial re-characterisation, where this risk is material in the light of our stated policy.

It is important that the senior management of firms are fully engaged in the execution of transactions that lead to a reduction in required capital (both providers and purchasers of structured trades), and that the purchasers of such products ensure that all factors, including high premiums, are adequately reflected when assessing any transfer of risk to ensure compliance with our rules.

(1) Firms are reminded that, in accordance with BIPRU 5.2.4R, they 'must take all appropriate steps to ensure the effectiveness of the credit protection arrangement and to address related risks'.