

PRESIDENCY NON-PAPER

Re-Securitisation (Article 5r of STS)

In preparation for the final negotiations with the European Parliament ("EP") and the European Commission on the STS Package ("STS Regulation and the Amending CRR"), the Presidency has prepared a non-paper on Article 5r of the proposal for the STS Regulation.

The two issues considered by this Non-Paper relate to the definition of 're-securitisation' and the ban thereon, each of which is discussed in turn below.

A. Definition of re-securitisation

The alternative definitions of 're-securitisation' being considered under Line 65 are as follows:

- The definition of proposed by Council: *securitisation where the risk associated with an underlying pool of exposures is tranced and at least one of the underlying exposures is a securitisation position*
- The definition proposed by the Commission and the EP: *securitisation where at least one of the underlying exposures is a securitisation position*

Council text clarifies the situation for ABCP, which should not be considered as re-securitisation as further explained further below in this Non-Paper. Council text also aims at aligning the definition with Article 4(1)(63) of the CRR. This definition (amended further as necessary) would be useful if the EP were to insist on a total ban on re-securitisation as per Option 1 in Section B below.

The definition of re-securitisation is considered further in section C below, which takes into account the position reached at technical level to the effect that the proposed Commission and EP is acceptable provided that, if a ban on re-securitisation is agreed to by Council, appropriate carve-outs (including the aforementioned ABCP clarification) are included in Article 5(r) proposed by the EP.

B. Ban on re-securitisation

The discussion on the introduction of a ban on re-securitisation was initiated by the EP, when it proposed the introduction of Article 5r which effectively imposes such a ban, total and unconditional. In introducing this Article, the EP noted the importance of ensuring that rules are adopted to better differentiate simple, transparent and standardised products from complex, opaque and risky instruments. In the explanatory statement of the draft report on the STS Regulation dated 6 June 2016, it was observed by the EP that re-securitisation should be banned in order to improve transparency, reduce complexity, promote alignment of interests and deter threats to financial stability.

The options considered during the course of discussions on this EP proposal are predominantly three:

1. Total ban on re-securitisations

A complete ban on re-securitisations, as proposed by the EP. This has been challenged by Council principally on the basis that it would not be proportionate to the risks presented by re-securitisations, and that indeed it would disregard the positive uses for re-securitisation in particular contexts.

2. No ban on re-securitisations

The revised Basel securitisation framework is considered to have already addressed the risks associated with re-securitisation by requiring significantly increased risk weights (*see Basel Committee on Banking Supervision, 'Revisions to the securitisation framework' (11 December 2014) section F*). Indeed, re-securitisations are already subject to a significantly higher risk floor of 100% and the deterrent effect of such higher regulatory capital charges is a more appropriate manner to address any concerns in respect of these arrangements for entities subject to the relevant prudential standards. Given that re-securitisation transactions currently represent only a minimal portion of the securitisation market and given also the significantly higher risk-weights to which re-securitisation transactions will be subject, it is highly unlikely – if not impossible in practice - that the 're-securitisation market' would ever develop to an extent that could potentially be harmful to the securitisation market as a whole and to its participants or would create any form of systemic risk.

Further, the broad definition of re-securitisation is likely to create unintended consequences by including within the ban certain positive uses of re-securitisation. A total ban may also lead to regulatory arbitrage opportunities that move these products into unregulated space.

A variation to this Option 2 could be to provide for no ban to be put in place at the date of entry into force of the Regulation, but allowing for the possibility of a ban being introduced by the Commission, in consultation with the relevant ECAs, which would be mandated to undertake a review of the European re-securitisation market with the aim of restricting or prohibiting re-securitisation activity where this is deemed necessary by the results of the review.

3. Possibility of banning re-securitisation subject to certain important carve-outs

Since re-securitisations display an inherent opacity which introduces a multi-layer structure and therefore run contrary to the simplicity and transparency objectives, the banning of certain re-securitisations would appear plausible, at least superficially. All parties have in fact already agreed to a ban on re-securitisation within the STS context (following the logic that re-securitisations should not be afforded the lower risk-weights applicable to STS transactions). The question is whether re-securitisation in the non-STS context should also be prohibited.

Even if a ban on re-securitisation in the non-STS context were to be agreed to by Council, this should not be a complete ban of all re-securitisations, and article 5(r) should include clear carve-outs from the applicability of any such ban. It should be noted, however, that this would nonetheless not represent an ideal solution given the risk of such carve-out not adequately addressing the unintended or unforeseen consequences of an outright ban: Council cannot guarantee that it has provided carve-outs that will cover all instances where re-securitisation transactions may be necessary in the future. Accordingly, a form of review clause could be provided for, pursuant to which the Commission could, in consultation with the relevant ECAs, be mandated to undertake a review of the European re-securitisation market within a specified period from the date of entry into force of the Regulation and thereafter as may be considered necessary by the Commission from time to time, with the aim of considering whether the list in article 5(r) merits amendment.

As already indicated above, in certain circumstances, the use of re-securitisations may be perfectly legitimate. Indeed, in certain cases, re-securitisations may prove necessary to ensure the preservation of the interests of the investors, such as where a restructuring is deemed necessary in cases where the underlying exposures are non-performing. The European Central Bank, in its report "Guidance to banks on non-performing loans" of March 2017¹ noted that "*it is acknowledged that NPL risk transfer and securitisation transactions can be beneficial for banks in terms of funding, liquidity management, specialisation and efficiency.*" It may not be excluded that some securitisations of non-performing loans (NPLs) will have to be restructured, and in such cases, re-securitisation could clearly be a way forward. One important qualification in this respect is that a securitisation that is being repackaged (into a securitisation) should not itself include (re-) securitisations in its underlying exposures. Naturally, defining what constitutes a 're-structuring', and determining exactly what types of re-structuring should or should not be permissible, could prove to be problematic.

In light of the impossibility of streamlining, across all member states, the situations in which re-securitisations ought to be considered legitimate (and should therefore not be captured by the proposed ban), the competent authority of each Member State (in consultation with other authorities such as resolution authorities where appropriate) should be entrusted with the discretion necessary for it to decide whether a re-securitisation should be permitted or otherwise, particularly (or only) where this does not fall squarely within any proposed carve-out to be inserted in article 5(r). The competent authority should therefore be enabled to permit a supervised entity to make use of re-securitisations if these are economically reasonable, such as in: situations of institutions experiencing, or threatened by, severe problems, or facing winding up; ABCP transactions; and other transactions that may inadvertently be affected by the application of a ban, such as restructuring, rebalancing or winding down of old deals for risk management purposes. In such cases, the competent authority should notify ESMA of a permission granted.

From a grandfathering perspective, it is considered that any bans on re-securitisation should only be applicable in relation to future transactions (which in any case are not expected to be issued owing to rating issues and the lack of investor interest), such that existing securitisation transactions would be exempt (to be provided for under the grandfathering

¹ https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf

provisions in Article 28). Existing transactions are difficult to unwind, particularly as they typically involve external investors whose consent may not be forthcoming. Existing transactions are also difficult to sell – a total ban on re-securitisations would effectively preclude the existence of a secondary market. It is also important to note that almost all of the previous poor quality structures have already defaulted, and been removed from the investment universe. In light of the aforesaid there is significantly reduced merit for a ban on re-securitisations.

A variation to this Option 3 could be to include a ban in the level 1 text but that would only come into effect following appropriate level 2 measures being issued that would determine the extent of the ban and, therefore, a list of appropriate carve-outs that would still be permissible. As indicated above, the contents of this list remain subject to review by the Commission, in consultation with the relevant ECAs, with the aim of considering whether the list in article 5(r) merits amendment from time to time.

C. Possible Compromises

In pursuing Option 3 above, the Presidency has considered the following compromise proposals if a ban on re-securitisation in the non-STS context were to be agreed to:

1. implement a grandfathering clause to expressly exclude from the applicability of the ban all re-securitisation transactions issued prior to a specified date (date of entry into force of the Regulation). This would effectively result in the banning of the purchase of new re-securitisations (save for new transactions that are carved out as indicated in section C(2) below), but allowing the holding of existing re-securitisation transactions and also allowing the buy back of existing re-securitisation transactions to close them down;
2. implement, in Article 5(r), a list of carve-outs for new re-securitisations that are undertaken for legitimate purposes, including:
 - a. ABCP transactions;
 - b. winding up scenarios;

- c. subject to securitisations that are being repackaged not themselves including securitisations as underlying exposures:
 - i. repackaging of securitisation transactions where underlying exposures are non-performing;
 - ii. repackaging of securitisation transactions where necessary to preserve the interests of the investors;
 - iii. repackaging of securitisation transactions where necessary for risk management purposes;
- d. other transactions that may inadvertently be affected by the ban, to be considered carefully at technical level prior to implementation;
- e. other transactions that, pursuant to a review of the European re-securitisation market to be carried out by the Commission in consultation with the relevant ECAs within a specified period from the date of entry into force of the Regulation and thereafter as may be considered necessary by the Commission from time to time, are considered as meriting inclusion in the list set out in article 5(r) (as amended from time to time as aforesaid).

Approval by the relevant Competent Authority would be given by reference to such list. Regulatory Technical Standards may be issued by ESMA by a specified date if the need for expansion or clarification of the list were to be considered necessary. Guidance (in the form of examples included in level 1 text) to Member State Competent Authorities as to which transactions fall within the 'legitimacy carve-out' is to be defined in level 1;

- 3. taking into account the preceding point in respect of the need for carve-outs from a total ban, and assuming that a compromise may be reached in that respect, given that the definition of securitisation already provides that the risk is tranching, the EP text would appear to be sufficient. If the EP definition were to be retained, the definition in Article 4(1)(63) of the CRR could be amended to cross-refer to the definition under the STS Regulation;
- 4. at technical trilogue level, in support of point 2 above, propose clarifications on the issues of re-tranching and ABCPs. In so far as re-tranching is concerned, it is pertinent to note that, in line with clarification provided by the Basel Committee in its Basel III

Document² entitled "*Revisions to the securitisation framework*" of July 2016, it was submitted that the definition of re-securitisation should also include reference to the fact that an exposure resulting from re-tranching of a securitisation position is not to be considered as re-securitisation if the cash flows of this exposure could be replicated in all circumstances and conditions by an exposure to the securitisation of a pool of exposures that contains no securitisation position. Article 2(4) (Line 65 STS) may be amended accordingly. With respect to ABCPs, article 12(1d) (Line 455 STS) merits further clarification, to the effect that the exposures underlying the ABCP transaction shall not include exposures which are securitisation positions of other securitisations;

5. amend recitals (in addition to level 1 text as indicated in section C(2) above) as necessary to clarify that with respect to re-securitisation, it is necessary to acknowledge the need, in exceptional circumstances, to allow securitisations to be repackaged into a securitisation where, for example, the underlying exposures are non-performing or in other circumstances to preserve the interests of the investors - however, to avoid re-securitisations in chain and to ensure transparency, the use of re-securitisations should be restricted to cases where securitisations that are being repackaged do not themselves include securitisations as underlying exposures.

D. Conclusions

The utility and need of re-securitisations should not be dismissed outright. There have been instances where re-securitisations have been used to assist with struggling banks and with the winding up of banks, and may also be helpful for the purpose of reduction of risks and refinancing in connection with winding down other financial entities as well as for the purpose of future resolution actions. Accordingly, Council is strongly opposed to a total ban on re-securitisations as proposed by the EP. On the other hand, in the context of ongoing discussions with the EP on the STS package as a whole, and taking into account the dearth of interest in the market for new re-securitisations, conceding the banning of future re-securitisations which do not qualify for the carve-out mechanism to be proposed by Council (refer to section C(2) above) would appear to be a pragmatic compromise.

We hope that this non-paper will be helpful in your analysis of the position. We look forward to hearing your views.

² available at: <http://www.bis.org/bcbs/publ/d374.pdf>