



Presidency Non-Paper

Hierarchy of Methods (Article 254 of CRR)

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 254 of the proposal for a Regulation amending CRR. The aim of this non-paper is to try to summarise in a concisely manner the points, arguments, facts and issues that have been raised already, with the main aim to facilitate the discussion on the hierarchy of methods at the upcoming Working Party on Financial Services (Securitisation).

At the 5th Political trilogue on Securitisation held on the 12 April, the EP has indicated strong willingness to re-discuss Article 254 CRR at the next trilogue, in mind of the overall package to be agreed among institutions. As indicated in the following Presidency Flash, the EP has made it clear that this issue is of outmost importance and a European solution is to be found.

It should be recalled that during the Council discussions in 2015, a number wide-ranging alternatives to the original Commission Proposal were considered which are being listed as follows:

- Strict application of the BCBS hierarchy as set forth in the Basel III document "Revisions to the securitisation framework" (11 December 2014)¹;
- Removal of the ERBA approach from the hierarchy of methods. The pros and cons of this option are set in the Annex of this non-paper.
- Alternatively, the removal of ERBA from the hierarchy would apply only to STS securitisations but would apply to non-STs securitisation. This option is favoured in the Opinion of the European Central Bank (ECB) to the STS Proposal².
- Reversal of the hierarchy of methods with regards to SEC-ERBA and SEC-SA, i.e. the new hierarchy of methods would be 1. SEC-IRBA, 2. SEC-SA, 3. SEC-ERBA.

¹ BCBS Revised Version [July 2016] <http://www.bis.org/bcbs/publ/d374.pdf>

² ECB Opinion [CON/2016/11] https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2016_11_f_sign.pdf (p.66 -68)

- Use of 'uncapped' ratings for applying the SEC-ERBA. However, this would require CRA's availability to disclose uncapped ratings on a voluntary basis with all the consequent risks attached to the uncertainty around CRAs' future behaviour.

In the end, an intermediate solution was agreed building on the Commission proposal while allowing for the framing of the flexibility to use SEC-SA instead of SEC-ERBA if the following conditions are met (i) SEC-SA is used for senior tranches of high quality 'STS' securitisation only; (ii) it is used only where the capital requirement resulting from SEC-ERBA is 25% or more higher than the one that would result under SEC-SA for the securitisation tranche under consideration; and (iii) where the risk weight resulting under the SEC-SA would be 25% or lower. The competent authorities have the final say and can object to the switch and impose the use of SEC-ERBA on a case-by-case basis.

The EP took an alternative approach to Council's compromise text. The EP opted for a switch between SEC-ERBA and SEC-SA (i.e. placing SEC-IRBA at the top, SEC-SA in the middle and SEC-ERBA at the bottom of the hierarchy). During the trilogue negotiations, the EP argued that this approach is necessary to make the capital securitisation framework more consistent across the EU, reduce reliance on external ratings as well as reduce the dispersion of capital charges for securitisation, and capital charges for banks' investments in senior tranches of securitisation in general. In addition, the EP introduced additional elements in the hierarchy allowing for a limited possibility of inversion of the hierarchy (i.e. putting SEC-ERBA ahead of SEC-SA) in some specific cases, such as for example when application of SEC-SA would result in capital charges 25% in excess of the amount if SEC-ERBA was used, for rated positions. Lastly, the EP also introduced another new element that allows the use of SEC-ERBA for pools of auto loans, auto leases and equipment lease transactions.

The discussion on changes to the hierarchy have been ongoing for quite some time and notwithstanding the extensive technical input provided, especially from supervisory institutions, a common agreed solution that satisfies both the goal of keeping with the Basel framework while at the same time considering certain European realities, notably concerning hard sovereign rating ceilings, has never been identified. The main challenge has always been in trying to merge conflicting policy objectives. Indeed, on one hand removing external ratings from the regulatory approach to securitisation would raise the issue of the inconsistency with the rest of the CRR framework (and the with the framework applicable to insurance undertakings) where ratings continue to play a role (external ratings still play a significant role

in the capital and liquidity regulatory frameworks). On the other hand giving excessive prominence to the use of SEC-ERBA could be detrimental to sovereign rating capped securitisations which may be more harshly treated than their likely credit performance would imply. At the same time, giving priority to SEC-ERBA over SEC-SA maybe warranted given that the former ratings based approach also considers other risks that may not necessarily be addressed under the latter formulistic approach. Other factors as referred to in Annex I are to be considered in any proposed way forward.

Possible way-forward

In view of the Presidency, by taking into consideration all the above considerations and the issues raised in previous discussions within Council and with the EP and Commission during trilogue negotiations, there are three possible options to take as way-forward towards a final agreement.

1. Use the Council GA with further increased flexibility – So far the Presidency has defended the Council GA as the most balanced approach. Nevertheless, the EP has repeatedly advised that the Council compromise text is not satisfactory as it would still lead to a high dispersion of capital charges for securitisation across Europe due to the extensive use of SEC-ERBA. To unblock this deadlock, the Presidency could propose to the EP to keep the Council GA (and thus keep with the BCBS framework) but introduce further flexibility to address EP concerns. One solution is to lower the quantitate limit of 25%. It should be mentioned that in the Council compromise text under Article 254 (8), which refers to the mandate to the Commission to review through a delegated act the excess percentage of the SEC-ERBA as compared to SEC-SA, the range of manoeuvre is set between 15% and 35%. In addition, it could be also proposed to open up to the switch from SEC-ERBA to SEC-SA also to non-qualifying securitisation products and to non-senior tranches. This would address the concerns of having an asymmetric regulatory framework and avoid the 'cliff effects' in the capital charges between qualify and non-qualifying securitisation products. Moreover, from a theoretical perspective, it could be argued that the STS criteria are not designed to address specifically country risks but simply ensure high quality of structures and underlying assets. Hence it might be difficult to substantiate the argument to exempt only STS securitisations from the 'impact' of external ratings.

2. Use the EP text with enhanced safeguards – A second option would be to accept the EP proposal subject to the introduction of very strict safeguards, in particular to avoid the risk of having a form of rating cherry picking where credit institutions are permitted to rely on external rating precisely in cases where it grants a defined benefit in terms of lower capital charges. The EP text seems to partially address such circumstances where the use of the SEC-ERBA is based on “unduly low” external ratings. Under Article 254 (2)(2) [Line 251], competent authorities may still require the institution to switch back apply a different method. However further clarity on this point might still be warranted. Another point to take into consideration is whether to allow certain derogation from being eligible to the switch such that introduced in Article 254 (2c) [Line 250]. These kinds of exceptions, could, in theory, lead to further asymmetries and complexities in the regulatory framework, and would be against the objective to introduce a consistent regulatory solution and minimise regulatory arbitrage.
3. Revert to the original Commission proposal – The Commission Proposal could be considered as a middle option solution that bridges the differences between the Council and EP approaches. To recall, the Commission Proposal respects the hierarchy of methods as provided by the BCBS, but grants a certain amount of flexibility to use SEC-SA instead of SEC-ERBA if the RWA resulting from the application of the SEC-ERBA are not commensurate to the credit risk embed in the exposures underlying the securitisation. During the Council negotiations, this option was in general accepted by many Member States as a fall-back solution to the adopted framed flexibility solution, without having to deviate from the BCBS hierarchy order.

The Presidency would like to invite Member States to express their views and preferences on the possible proposed way forward listed above, keeping in mind the importance of the overall balance that needs to be reached and agreed with the institutions.

ANNEX I

Considerations regarding excluding the SEC-ERBA approach from the hierarchy for qualifying securitisations

Views in favour	Views against
The regulatory capital framework for securitisation positions becomes less reliant on external ratings, promoting the EU and G20 general regulatory objective of reducing such reliance. The reduced reliance on external ratings would be undertaken in a prudent manner, as securitisations with low underlying credit quality would not qualify as STC.	Enhanced complexity for less sophisticated investors, as the formulae-based approach (SEC-SA) is operationally more complex than the look-up table approach (SEC-ERBA).
The high non-neutrality of securitisation capital charges due to sovereign rating ceilings is addressed, improving the level playing field for issuers belonging to those sovereigns and helping re-establish the principle that approaches which rank lower in the hierarchy cannot lead to lower capital charges than approaches ranking higher.	The overall risk-sensitivity of the framework may be reduced as sovereign risk and other risks taken into account within ECAIs' rating methodologies, but not fully addressed by the 'qualifying' requirements, are likely to affect the credit risk of the securitisation tranche in a number of ways.
Regulatory level playing field is enhanced between EU and US securitisation markets; in the latter, the use of the external ratings for regulatory capital purposes is already banned by regulation.	Overall prudence of the capital requirements framework may be reduced if the use of external ratings is materially reduced as the rating activity constitutes a third-party analysis of the features of riskiness of the transaction, analysis which would be left to issuers and investors (and regulators).
Potential double counting of the 'qualifying' features of the transaction would be avoided: ECAI's rating methodologies take into account many of the features that the SST framework is setting in rules. A better rating resulting from the assessment of these features by the ECAI would result in a better risk weight treatment, where the transaction has already been assigned a relatively better risk weight treatment due to the proposed differentiation in the rules. The double counting	<p>The overall risk-sensitivity of the framework may be reduced to the extent that issuers/originators will not be able to use the IRBA (due to a lack of necessary information and data inputs). They will have to adopt the SEC-SA approach, which is designed to be the least risk-sensitive.</p> <p>Increased use of the SEC-SA may also result in:</p> <ul style="list-style-type: none"> • transactions backed by lower quality portfolios receiving lower capital charges as the conservative credit enhancement levels

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would not result from formulae-based approaches (i.e. SEC-IRBA, SEC-SA) to capital requirements;	structured to address such risk, lower the capital charges in the formulae of the SEC-SA; <ul style="list-style-type: none"> • an amplification of the potential deficiencies of the standardized approach of the credit risk framework, upon which the SEC-SA is based.
The consistency of capital requirements should increase, as SEC-IRBA and SEC-SA are based on a similar formulae based approach and result in limited dispersion of risk weights, while the look-up table approach of SEC-ERBA results in more dispersed capital requirements, versus both SEC-SA and SEC-IRBA.	

Source: EBA Report on Qualifying Securitisation (Table 7, pg. 100)