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The UK's PRA Discusses Securitisation Capital Requirements and Basel 3.1

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The UK's banking regulator, the Prudential Regulation Authority ("PRA") has published a Discussion Paper (DP3/23) covering securitisation bank capital in the context of: (1) the Basel 3.1 output floor and capital requirements for securitisation exposures; (2) a review of the hierarchy of methods for determining capital requirements for securitisation exposures; and (3) the scope of the framework for simple, transparent and standardised ("STS") securitisations, as covered in the PRA's consultation on the *Implementation of the Basel 3.1 standards* (CP16/22). DP3/23 aims to collect data and feedback from firms prior to transferring the firm-facing requirements in the Securitisation Chapter of the Capital Requirements Regulation ("CRR") into PRA rules in alignment with Basel 3.1 standards.

1. *The output floor and securitisation exposures:* The PRA is considering a range of policy options to deal with potential impacts of the Basel 3.1 output floor and its interaction with the Pillar 1 securitisation capital framework, particularly for retained senior tranches of synthetic significant risk transfer securitisations ("SRT").

- To recap, CP16/22 set out the requirements of the output floor as requiring firms to calculate total risk-weighted assets ("RWAs") for the purpose of compliance with Pillar 1 capital requirements as being the higher of: (x) total RWAs using all approaches with regulatory approval, including internal models, and (y) 72.5% of total RWAs calculated using only the standardised approaches ("SAs").

- A firm will be subject to the output floor if its RWAs after its application exceed its RWAs before its application.

- For securitisations, the hierarchy of SAs include the securitisation standardised approach ("SEC-SA"), the securitisation external ratings-based approach ("SEC-ERBA"), or a risk weight of 1250%. The SAs do not include

the securitisation internal ratings-based approach ("SEC-IRBA") or the securitisation internal assessment ("SEC-IAA").

- The output floor is applied at aggregate level and therefore does not directly affect securitisation exposure-level RWAs or securitisation transaction-level supervisory assessments. However, the PRA recognises that: (a) the difference between RWAs for particular exposures between the internal model and SA approaches will drive up overall post-output floor RWAs; and (b) there are concerns about the implications for retained senior tranches of synthetic SRT transactions. This is because the retained senior unprotected tranches are generally risk-weighted using SEC-IRBA.

- DP3/23 floats a couple of potential mitigating actions, including: (a) obtaining and maintaining a rating from an external credit assessment institution or ECAI for exposures for which it is not already available in order to use the SEC-ERBA approach (though this would be only a partial mitigant not available to exposures to third-party securitisations); and (b) buying extra credit protection to reduce both Pillar 1 requirements and the differences between the calculations between the three SA methods.

- The PRA considers that some degree of capital non-neutrality remains justified for securitisations, but is not clear as to whether the current 'p-factor' capital surcharge regimes should remain at their current levels or indeed whether a single non-neutrality parameter would work.

- The PRA is looking at three policy options. The first is to implement the output floor without any Pillar 1 adjustments. While this aligns with CP16/22's stated aim of implementing the output floor for all exposures including securitisations, there is a clear disadvantage for UK banks originating SRT securitisations and risk-weighting-retained exposures using the SEC-IRBA. Policy option two would involve adjusting the Pillar 1 framework for securitisation exposures by reducing the p-factor in the Pillar 1 SEC-SA to bring its level of non-neutrality closer to SEC-IRBA and reduce capital requirements for all securitisation exposures using the SEC-SA method to calculate Pillar 1 capital requirements. Option three involves carve-outs from, or other qualifications to, the output floor for some or all securitisation exposures. The PRA notes that a variant of option three has been included in European proposals for Basel 3.1 implementation that allow firms to lower p-factors for STS and non-STS securitisations when calculating securitisation RWAs under the SEC-SA for output floor purposes. The PRA indicates that it is not minded to pursue option three and similarly reduce the p-factor in this way, but rather prefers targeted adjustments to SEC-SA.

2. *The hierarchy of methods for determining capital requirements for securitisation exposures:* The PRA is exploring divergence between the UK (CRR) hierarchy and that required by Basel standards, and its preliminary view is that a change of the securitisation hierarchy of methods in the UK to align with that of the Basel standards may be preferable. In summary, this would involve replacing SEC-SA as the second position in the hierarchy with SEC-ERBA in the event a bank cannot use the SEC-IRBA. SEC-ERBA is generally considered more risk-sensitive than SEC-SA, though there are clearly operational and cost implications to changing the hierarchy of

methods to align with Basel standards.

3. *The scope of the framework for STS securitisations*: Basel standards only allow for preferential capital treatment for exposures to qualifying traditional securitisations, and the PRA considers that expanding this treatment to synthetic securitisations would not be in line with its objectives, particularly that of supporting the safety and soundness of PRA-authorised firms. While noting that the EU extended its STS framework to include qualifying synthetic securitisations from April 2021, the PRA also questions how susceptible SRT securitisations are to STS requirements.
4. *The use of credit risk mitigation in synthetic SRT securitisations:* The PRA is asking for information on credit risk mitigation in synthetic SRT securitisations in order to identify prudential risks and, if necessary, appropriate mitigants. Of particular interest is information on market practice and risks associated with using unfunded credit risk mitigation.

Next Steps

The consultation period ends on 31 January 2024, and the PRA envisages additional engagement with the industry to gather data. The transfer of firm-facing CRR rules to the PRA is planned to take place in the second half of 2024.