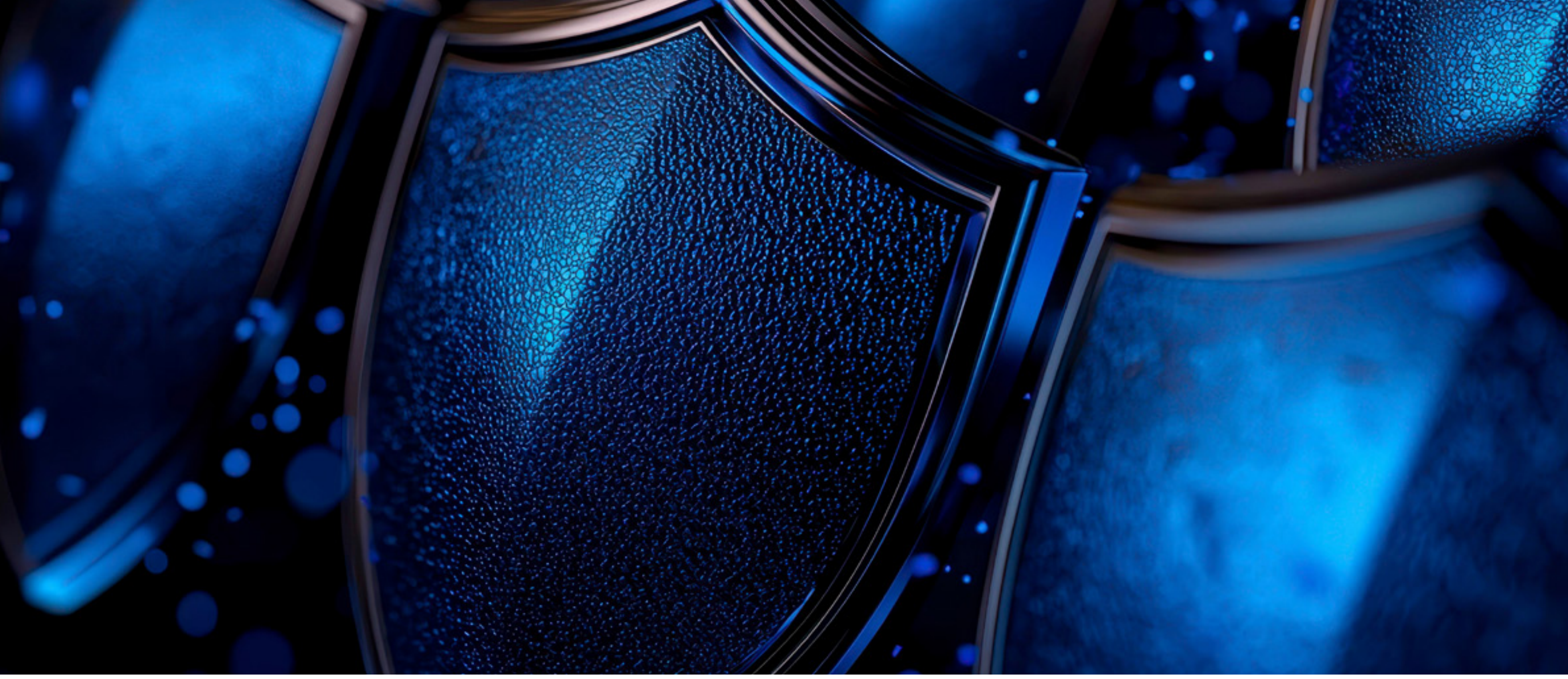
Insurers in the securitisation market: Prudential capital and risk transfer

Background

The Basel Accords have, over time, shaped the development of the financial markets as different products become more or less attractive for banks to offer and businesses to take up on a risk-adjusted return basis. After the financial crisis, the Basel III accords greatly increased the sophistication of the regime and addressed different areas of risk which, it was felt, had been insufficiently provided for with consequent risks to financial stability. The latest iteration, Basel 3.1, was finalised in 2017, but political agreement on implementation has been slow in coming. In most jurisdictions, including the EU, UK and US, it is only in the past year or so that these newest updates and revisions are starting to appear in legislative and regulatory dialogue, and banks are starting to prepare for implementation.

In the UK and Europe, the legislation governing prudential capital for banks is set out in the Capital Requirements Regulation ("**CRR**"),[1] which implements the Basel Accords in the EU and in the UK through assimilated law. Similar regimes therefore apply in both jurisdictions. In the EU, Basel 3.1 has now been mostly implemented into legislation (with the exception of the Fundamental Review of the Trading Book) and has been effective since 1 January 2025, albeit transitional periods apply. In the UK, the Prudential Regulatory Authority or PRA (responsible for prudential regulation of banks and insurers) is in the process of implementing Basel III as part of the UK's wholesale transition of financial services legislation from assimilated EU statutes to the "handbooks" of the PRA and the Financial Conduct Authority ("**FCA**"). The PRA proposals have been set out in various consultations and discussion papers in recent years, and implementation has recently been pushed back until 1 January 2027.

1. EU CRR – https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575
UK CRR – https://www.legislation.gov.uk/eur/2013/575/contents



Output floor

One key aspect of Basel 3.1 is the introduction of an "output floor", whereby a floor is imposed on the reduction in risk-weighted assets that a bank can achieve by using the internal model-based approach ("**IRB**"). Banks using the IRB approach to calculate the risk weight of some or all of their exposures will now have to assign an overall value to their risk-weighted assets of no less than 72.5% of the outcome of the calculation under the standardised approach. The impact of this will be mixed depending on the bank and the asset category. However there is an overall trend where banks are less able to hold positions lower in the capital structure, and balance sheet optimisation transactions intended to mitigate the effect of this while still allowing the institution to continue to offer business in the relevant product type have been, and are likely to continue to be, a significant part of the market in the coming years.

Many voices in the securitisation industry advocated for a derogation from the imposition of the output floor to securitisation positions, arguing that the standardised approach gives rise to a disproportionate outcome for certain kinds of securitisation positions which limits the use of securitisation for capital optimisation purposes. Neither EU nor UK authorities have been minded to deviate from the Basel standards, but both authorities have indicated a willingness to look again at the calculation under the standardised approach. The PRA has suggested a permanent lowering of the "p-factor" (a key multiplier forming part of the standardised approach calculation) in order to mitigate the impact of the output floor. The EU, meanwhile, has implemented a temporary halving of the p-factor until December 2032, along with a staggered implementation of the output floor itself. EU Commission ("EC") proposals, which were recently made public via a regulatory news service, suggest that permanent changes to the p-factor are under consideration, introducing a more nuanced range of outcomes depending on the nature of the transaction and the position held, and a differentiated treatment depending on whether the position is held as investor or as originator/sponsor. A new category of "resilient" transactions is discussed, which would allow greater advantages than equivalent senior tranches of both STS and non-STS transactions in some scenarios.[2]

Risk transfer and credit insurance

Eligible credit risk mitigation under the CRR

Credit risk insurance is commonly used by banks for balance sheet optimisation purposes, qualifying (provided relevant conditions are met) as eligible credit risk mitigation ("**CRM**"). CRM under the CRR can be provided in various ways, including through the use of funded or unfunded credit derivatives and guarantees. Credit insurance is not explicitly referenced in the CRM chapter of the CRR, but regulators have confirmed that it is capable of constituting unfunded CRM, being equivalent to a guarantee.[3] Having put in place CRM satisfying the relevant requirements as to the nature of the provider and the risk transfer agreement, a bank can reduce the risk-weighted exposure amount associated with an exposure or pool of exposures to take into account the protection against loss afforded by the CRM instrument.

Despite being a widely accepted and commonly used form of CRM, credit risk insurance still only represents a small portion of European banks' risk-weighted exposures,[4] so there is scope for use of the technique to increase. However, regulators have raised concerns in relation to the risks to financial stability posed by too many interconnected exposures within the financial services sector – memories of the role played by monoline insurers in the financial crisis remain fresh.[5] Basel 3.1 imposes a floor here too, on the reduction that can be achieved through the use of insurance as unfunded CRM. Other tweaks have also been made which are intended to reduce, but not eliminate, the benefit a bank can achieve from a risk-weighted asset perspective by using this technique.

Significant Risk Transfer

Significant Risk Transfer ("**SRT**") refers to the use of securitisation for risk transfer, whereby banks that transfer the credit risk in an asset or portfolio of assets to one or more third parties may be able to treat that asset or pool of assets as having moved off-balance sheet for capital purposes, and instead calculate their risk-weighted assets by reference to their exposure to any retained positions in the securitisation. SRT can be achieved through either a standard or synthetic securitisation. SRT under a standard securitisation involves a relatively standard cash securitisation structure, including the transfer of assets to an

2. https://www.mlex.com/mlex/articles/2345778/european-commission-reviews-securitization-framework
3. https://www.eba.europa.eu/sites/default/files/documents/10180/2087449/2644c0e5-6007-4652-8839-993b40bed22e/EBA%20Report%20on%20CRM%20framework.pdf – for EU https://www.bankofengland.co.uk/prudential-regulation/publication/2022/november/implementation-of-the-basel-3-1-standards – for UK
4. https://www.eba.europa.eu/sites/default/files/2024-10/4f392d3d-289b-4286-aa78-d3ea2aca1744/Report%20on%20credit%20insurance.pdf

SPV through a true sale. In a synthetic securitisation, SRT is achieved by tranching the risk associated with the relevant asset or assets using an eligible CRM instrument, so the receivables remain on the bank's balance sheet from a legal perspective.

Synthetic SRT transactions must comply with more criteria than equivalent cash trades to achieve the same effect, but the transactions themselves can be considerably simpler to implement, in many cases requiring only a confirmation under an existing ISDA agreement.

Issuance of SRT securitisation has seen a significant increase in the EU in recent years – with annual issuances rising from €36 billion to €102 billion between 2016-2023.[6] This trend is supported by various sources, including reports from the EBA and the European Systemic Risk Board.[7] The increase in SRT issuance underlines the importance of the risk transfer market and the growing role of securitisation within it.

Use of Synthetic SRT in Europe vs. the UK

Data suggests that synthetic SRT is more common in Europe than in the UK, with some analysts estimating that the European market constitutes up to 85% of global SRT trades.[8] This is most likely due to the availability under the EU regime of obtaining Simple, Transparent, and Standardised (STS) status for synthetic securitisations, which has not been implemented in the UK. A bank executing an SRT trade and retaining the senior tranche of the securitisation will enjoy a greater benefit if that senior tranche is STS. To achieve this in the UK, a bank must execute a cash securitisation.

Credit risk insurance as CRM in securitisation deals: EU

Credit risk insurance, if qualifying as eligible CRM, can be used to create a synthetic securitisation under Article 249 CRR, which would be capable of achieving SRT. In both EU and UK securitisation markets, however, the use of credit protection for this purpose is considerably less common as compared with (for example) a collateralised credit default swap or a credit linked note.

In the EU this kind of risk transfer cannot obtain the STS label because credit risk insurance is, in the absence of any structural enhancements, unfunded (in that payments will only be transferred to the counterparty if a credit event occurs, rather than being provided upfront). The list of providers eligible under the EU CRR to provide unfunded credit protection in STS deals does not include insurance providers, meaning that they are, in practice at least, excluded from transactions requiring the label. According to a recent report by the European Systemic Risk Board, as at the second quarter of 2024, 87% of the outstanding amount of synthetic securitisations in the EU were executed using funded credit protection provided by private investors, while 13% comprised unfunded credit protection offered by multilateral development banks.[9] These regulatory barriers to the use of credit risk insurance in SRT trades have been acknowledged in the recent EC proposals. The EC has suggested allowing unfunded credit risk insurance to be used for STS transactions – subject to strict criteria as to the diversification, size, capital adequacy, and internal risk models of the insurance or reinsurance undertaking – although not for the new resilient category.

Regulatory announcements

Credit risk insurance as CRM in securitisation deals: UK

In the UK, the PRA has confirmed that it is possible for institutions to use unfunded credit protection, encompassing credit insurance providers, so long as other regulatory requirements are met.[10] Although this was arguably already the case under the black letter law, the clarification was made in response to market participants requesting clarity on the matter – suggesting that there may be appetite and now scope for growth in this area.

However, the PRA confirmed in DP3/23 that it does not intend to follow the EU in introducing a framework for synthetic STS in the UK.[10] This stance is likely to limit the impact of the PRA's recognition, because – as we have seen in the EU – inability to secure STS status is potentially holding insurers back in the SRT space.

Conclusions

The growth in the number of SRT transactions in recent years highlights the continued importance of targeted risk transfer for banks looking to remain competitive, especially with one eye on the future under Basel 3.1. Although it plays an important role in CRM generally, credit risk insurance lags behind in the context of synthetic securitisation, particularly due to the difficulty it has in qualifying for the STS label. Recent regulatory updates indicate cautious encouragement for the use of insurance capacity for this purpose, although some disincentives remain when compared with collateralised structures. It will be interesting to see whether banks may begin to look again at the untapped potential of credit risk insurance in this area, as Basel 3.1 and other regulatory changes work their way through.

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5. https://www.esma.europa.eu/sites/default/files/2025-03/JC_2025_14_Joint_Committee_report_on_the_functionning_of_the_securitisation_regulation.pdf
6. IACPM Synthetic Securitisation Market Volume Survey 2016-2023 (available at IACPM website)
7. https://www.esrb.europa.eu/pub/pdf/occasional/esrb.op23~07d5c3eef2.en.pdf
8. See Renault, O. (2022), "Significant Risk Transfer (SRT) Chronicles", Pemberton News and research.
9. https://www.esrb.europa.eu/pub/pdf/reports/esrb.report202505_syntheticSTSsecuritisation.en.pdf
10. https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2024/credit-risk-mitigation-ss.pdf#:~:text=7.2A%20The%20PRA%20considers%20that%20firms%20may,to%20the%20definition%20in%20CRR%20Article%204(1)(59).
11. https://www.bankofengland.co.uk/prudential-regulation/publication/2023/october/securitisation-capital-requirements

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