

Harmonisation and standardisation of synthetic securitisations

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SYNTHETIC SECURITISATION TRANSFERS THE CREDIT RISK OF A PORTFOLIO OF EXPOSURES BY MEANS OF A CREDIT PROTECTION AGREEMENT, WITHOUT TRANSFERRING THE OWNERSHIP OF THOSE EXPOSURES. THE SECURITISED EXPOSURES REMAIN ON THE BALANCE SHEET OF THE ORIGINATOR AND BECOME REFERENCE CREDITS OF THE CREDIT PROTECTION AGREEMENT. THE ORIGINATOR OF THE PORTFOLIO IS THE PROTECTION BUYER WHEREAS THE GUARANTOR OR COUNTERPARTY IN THE CREDIT DERIVATIVE IS THE PROTECTION SELLER.

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The Capital Requirements Regulation (CRR) as per Article 242(11) provides a definition of synthetic securitisation: *Synthetic securitisation means a securitisation where the transfer of risk is achieved by the use of credit derivatives or guarantees, and the exposures being securitised remain exposures of the originator institution.*

Synthetic securitisation and ‘true sale’ (i.e. traditional) securitisation may not fundamentally differ in terms of the nature of the underlying assets, credit risk tranching and capital structures, but they use two different ways of transferring credit risk from the originator to the investor. While traditional securitisation transfers the actual underlying portfolio and its ownership to a Securitisation Special Purpose Entity (SSPE), synthetic securitisation transfers risk by means of a credit protection contract between the originator and the investor, leaving the underlying portfolio within the ownership of the originator and on its balance sheet.

In a synthetic securitisation, therefore, the actual extent of risk transfer is a function of not only the capital structure and potential mechanisms of support from the originator, as it is the case in traditional securitisation, but also the features of the credit protection contract over which both

the originator and investor agree, and the creditworthiness of the originator’s counterparty in that contract.

Financial guarantors (in the case of financial guarantees) or swap counterparties (in the case of credit derivatives) agree to compensate the losses suffered by the owner of the reference portfolio if a credit event (e.g. a payment default) occurs in relation to those assets. In return, the owner of the reference portfolio agrees to pay the financial guarantor or the swap counterparty a premium based on



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the perceived probability of credit events occurring on the reference exposures in the portfolio. As a result, the financial guarantor or the swap counterparty gain exposure to the credit risk attached to the reference portfolio without title or any rights in these assets passing to them.

Types of synthetic securitisations

Synthetic securitisation can be structured in many different ways depending on several factors. A major distinction arises with respect to the objectives of the transaction, whereby two main types of synthetic securitisations can be identified: ‘balance sheet’ synthetic transactions and ‘arbitrage’ synthetic transactions.

In balance sheet transactions, the originating credit institution uses financial guarantees or credit derivatives to transfer to third parties the credit risk of a specified portfolio of assets that it holds on its balance sheet and that, in the vast majority of cases, it has originated. The third parties to which the credit risk is transferred include insurance companies, other credit institutions as well as unregulated entities.

The main objective of arbitrage synthetic securitisation (mainly CDOs – also called Collateralised Synthetic Obligations or CSOs) is one of arbitraging between the (higher) spread received on underlying lower credit quality debt or products indices (such as ITRX CMBX, ABX) and the (lower) spread paid on the resulting structured and credit-enhanced CDO note and usually embeds extra features such as leverage or foreign currency pay-outs. Arbitrage synthetic securitisations are usually investor- and/or asset manager-driven and are structured to achieve a desired portfolio profile in terms of seniority, rating and return desired by investors.

In addition, arbitrage synthetic transactions can be managed transactions, i.e. transactions where a portfolio manager is appointed to ‘actively’ manage the collateral underlying the synthetic CDO. By contrast, balance sheet deals are non-managed transactions and their performance exclusively depends on the performance of the securitised portfolio.

Significant risk transfer for balance sheet synthetic transactions

From an originator perspective, credit risk management and the related regulatory capital relief tend to be the main objectives of balance sheet synthetic transactions. As part of the credit risk management, originators engage in synthetic securitisation, *inter alia*, to manage their large exposure positions and concentration risk. Originators often transfer the junior (first and or second loss) element of the portfolio’s credit risk and retain a senior tranche of the same portfolio. Unlike ‘true sale’ securitisation, synthetic securitisation does not provide the originator with funding.

Originators may be incentivised to use synthetic rather than ‘true sale’ securitisation due to the greater flexibility of the synthetic mechanism, which tends to be cheaper and quicker to arrange and allows the originator to side-step the legal, confidentiality-related and operational difficulties that can be incurred in a true sale transaction when completing the transfer of ownership of the underlying exposures.

It should be kept in mind that a special purpose entity is never required for the segregation of the securitised exposures in synthetic transactions. In addition, whereas some funded synthetic transactions may set up an SPV for the issuance of notes (i.e. credit-linked notes), the SPV structure is not strictly necessary. The SPV is not used within unfunded synthetic transactions. For these reasons, market participants consider synthetic securitisation structures less burdensome and costly from an administrative perspective as well as less risky from a legal and operational point of view, even though the risk in the transaction is increased as a consequence of the counterparty credit risk introduced by the credit protection contract.

Regulatory and supervisory view on SRT

The regulatory framework for the SRT for synthetic securitisations is framed by the CRR Article 244 and the EBA Guidelines on SRT¹, the latter applicable since July



2014. The CRR sets out ‘tests’ for assessing whether a significant transfer of risk to third parties has been achieved for a given transaction, as well as additional requirements for assessing and recognising SRT. The EBA Guidelines, on the other hand, specify the requirements for both competent authorities and the originators in more detail.

Furthermore, the CRR requires the EBA to monitor the range of supervisory practices in relation to the recognition of significant risk transfer for all securitisations and to report its findings to the European Commission.

As a general principle, the quantitative SRT tests foreseen in the CRR Article 244 (the first loss test and the mezzanine test) focus on measuring the significance of the amount of risk transferred to third parties by means of post-securitisation capital requirements comparison, i.e. a comparison of the capital requirements for securitisation positions retained by the originator and the capital requirements for securitisation positions transferred to third parties.

While the quantitative SRT tests focus on the significance of risk transfer, the CRR also envisages the concept of commensurate risk transfer, with respect to the reduction in risk-weighted exposure amounts (for the transactions subject to the quantitative SRT tests) or the reduction of own funds requirements (for the permission-based transactions) achieved as a result of the securitisation. Such concept includes, in other words, a comparison of the risk-weighted exposure amounts or own funds requirements of the originator pre- and post-securitisation.

The concept of commensurate risk transfer is not defined by means of a quantitative and standardised test in the CRR, nor is it defined by means of any objective benchmark threshold. It is however a criterion which competent authorities may use to prevent securitisation transactions from achieving SRT, on a case-by-case basis, following an assessment of the transaction. Given the lack of a standardised threshold, current practices differ both among the supervisors as well as among the institutions on how to measure and test commensurate risk transfer.

From a prudential/supervisory point of view, a key aspect to be considered is the amount of credit risk that is effectively transferred to third parties and whether the regulatory capital relief claimed by the originator is commensurate with, and correctly reflects, that transfer. In the CRR, this is dealt with by the ‘significant risk transfer’ (SRT) rules in Article 244 as well as by the related EBA Guidelines.

The EBA Guidelines on significant risk transfer published in July 2014 indicate that the SRT requirements should be met on a continuous basis, i.e. not only when the originator first excludes the securitised assets from the calculation of risk-weighted exposure amounts, but during the whole life of the transaction. In order to ensure ongoing compliance, the EBA Guidelines provide that originators put in place the appropriate systems and governance for the ongoing monitoring of significant risk transfer and competent authorities monitor such compliance regularly.

The objective of ensuring compliance with SRT requirements on a continuous basis is twofold: (i) to ensure that at all times originators’ regulatory capital appropriately reflects the actual risk to which originators are exposed in the context of their securitisation activities; and (ii) to ensure that the originators’ capital requirements related to securitisation remain, to the extent possible, reasonably stable over time.

Securitisation transactions, in particular synthetic ones, may embed structural characteristics that are potentially detrimental to the compliance with SRT requirements on a continuous basis. The importance of specific structural characteristics is acknowledged in the EBA Guidelines on SRT, whereby reference to certain characteristics is made in, at least, the following sections:

- the conditions under which competent authorities should carry out a comprehensive assessment of the transaction;
- structural features within the comprehensive assessment of SRT; and
- credit protection issues within the comprehensive assessment of SRT in synthetic transactions.



CRR mandate on SRT for synthetics

Article 244(6) of the current CRR requires the EBA to review the implementation of the EBA Guidelines on significant risk transfer and to provide advice to the Commission by December 31, 2017 on whether a binding technical standard is required. Furthermore, the amendments to the CRR, which have been put forward as part of the STS securitisation reform, extend the mandate and mandate the EBA to specifically review a number of aspects with respect to the SRT. In particular, the new text requests the EBA's technical advice on:

- the conditions determining SRT in accordance with both the SRT quantitative tests and the permission-based SRT process;
- the concept of 'commensurate' risk transfer, which competent authorities can invoke on a case-by-case basis to decide whether or not significant risk is considered to have been transferred; and
- the requirements for competent authorities when assessing SRT.

According to the new mandate, the European Commission may adopt a Delegated Act, taking account of the EBA final report on SRT.

Based on this legal mandate, the EBA is currently reviewing both SRT market practices and the supervisory approach to SRT assessments, with the objective to further harmonise structural features of balance sheet synthetic transactions and to provide further supervisory clarity in this area, at least, on the following aspects:

- strengthening the prudential framework governing significant risk transfer in Europe, thus further limiting the scope for regulatory arbitrage in structuring securitisation transactions;
- enhancing regulatory certainty and clarity of the existing provisions and guidelines related to SRT, to increase market participants' understanding of and confidence in the regulatory framework;
- harmonising certain structural features, which could be detrimental to the objective of achieving SRT, such as, amortisation structure; call options; synthetic excess

spread; cost of protection; early termination events and credit events; and

- making the supervisory assessment of SRT more harmonised across Member States, thus enhancing regulatory level playing field within the European market for securitisations.

Simple, transparent and standardised securitisation and synthetic securitisation

In July 2017 the EU legislative institutions agreed a new EU regulation intended to lay down common rules on securitisation and to create a European framework for 'simple, transparent and standardised' ('STS') securitisation. They have also agreed changes amending the CRR provisions dealing with securitisation, which include a new hierarchy of approaches for calculating capital requirements on securitisation exposures and lower capital requirements for STS securitisations than for non-STS securitisations. The new regulation is expected to come into force in January 2018 and will be applicable to all securitisations from January 1, 2019.

Synthetic securitisations are classified as non-STS in the new regulation. However, Article 270 in the new CRR allows banks that retain, subject to certain conditions, senior positions of SME balance sheet synthetic transactions to benefit from the lower STS capital requirements.

The article follows the EBA recommendations specified in the EBA report on synthetic securitisation published in December 2015². In light of the evidence available at that time, the EBA supported the extension of STS capital requirements to senior synthetic tranches of SME portfolios that banks decide to retain when transactions benefit from financial guarantees by public bodies or credit protection arrangements by private investors that are fully cash collateralised. The EBA advised on the criteria that should determine eligibility of balance sheet synthetic transactions, specifying, among others, under which conditions originator banks may transfer the risk of eligible transactions to public or private investors.



The new STS regulation also includes a mandate for the EBA to assess the feasibility of a specific framework for simple, transparent and standardised balance sheet synthetic securitisations and for the European Commission to submit a report to the European Parliament and the Council on the establishment of a specific framework for simple, transparent and standardised synthetic securitisation, limited to balance sheet synthetic securitisation, together with a legislative proposal, if appropriate.

Future developments on synthetics

As mentioned above and in line with the current and future legal mandates, the EBA is currently drafting a discussion paper on SRT, which will be published later in 2017, to gather stakeholders' views on the EBA assessment and proposals in this area. The feedback received in response to this discussion paper will serve as an input in preparation for the final EBA report on SRT and for the report that the EBA shall submit to the European Commission in 2019 on the feasibility of a specific framework for STS balance sheet synthetic securitisation in Europe.

On a final note, it is our firm belief that balance sheet synthetic transactions could play an important role in the

capital and risk management of banks and, if properly structured, transfer real credit risk from banks to investors outside the banking system. It is, therefore, important that, over the next couple of years, the regulators, policymakers and industry stakeholders engage in a transparent dialogue to develop a more transparent and robust balance sheet synthetic securitisation market for the future.

Disclaimer:

The views expressed in the Article are those of the authors and do not necessarily reflect those of the EBA.

Notes:

- 1 <http://www.eba.europa.eu/regulation-and-policy/securitisation-and-covered-bonds/draft-guidelines-on-significant-risk-transfer-srt-for-securitisation-transactions>
- 2 <http://www.eba.europa.eu/-/eba-issues-advice-on-synthetic-securitisation-for-smes>

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