EBA DISCUSSION PAPER
ON STS FRAMEWORK FOR SYNTHETIC SECURITISATION

Public hearing, EBA, 9 October 2019

Mandate: Regulation (EU) 2017/2402 (Securitisation Regulation)

Article 45:

- 1. By 2 July 2019, the EBA, in close cooperation with ESMA and EIOPA, shall **publish a report on the feasibility of a specific framework for simple, transparent and standardised synthetic securitisation, limited to balance-sheet synthetic securitisation.**
- 2. By 2 January 2020, **the Commission shall**, on the basis of the EBA report referred to in paragraph 1, **submit a report** to the European Parliament and the Council on the creation of a specific framework for simple, transparent and standardised synthetic securitisation, limited to balance-sheet synthetic securitisation, **together with a legislative proposal, if appropriate.**

Recital 24:

- In securitisations which are not true-sale, the underlying exposures are not transferred to an issuer entity which is a SSPE, but rather the credit risk related to the underlying exposures is transferred by means of a derivative contract or guarantees. This introduces an additional counterparty credit risk and potential complexity related in particular to the content of the derivative contract. For those reasons, the STS criteria should not allow synthetic securitisation.
- The progress made by the EBA in its report of December 2015, identifying a possible set of STS criteria for synthetic securitisation and defining 'balance-sheet synthetic securitisation' and 'arbitrage synthetic securitisation', should be acknowledged. **Once the EBA has clearly determined a set of STS criteria specifically applicable to balance-sheet synthetic securitisations**, and with a view to promoting the financing of the real economy and in particular of SMEs, which benefit the most from such securitisations, **the Commission should draft a report and, if appropriate, adopt a legislative proposal** in order to extend the STS framework to such securitisations. However, no such extension should be proposed by the Commission in respect of arbitrage synthetic securitisations.

Background

EBA Report on synthetic securitisation (December 2015)

- **Analysis and market practice assessment of the synthetic securitisation market**
- In the report, the EBA has proposed **to extend the STS framework to fully-cash funded credit protection provided by private investors**
- The EBA recommendations have been reflected in the final CRR (Art. 270 of CRR).

Art. 270 of CRR

- **Allows for limited preferential capital treatment of SME synthetic securitisations on a limited basis:**
  - Senior tranches
  - Retained by the originator
  - Protection:
    - Either unfunded guarantees by supranational 0% risk weighted entities
    - Or by private investors through fully-collateralised guarantees

EBA Discussion Paper on significant risk transfer (September 2017)

- Detailed **proposals to strengthen the regulation and supervision framework of significant risk transfer (SRT)** associated with the traditional and synthetic securitisation
- Recommendations in three areas:
  - Process of SRT assessment by competent authorities
  - Structural features (incl. excess spread, pro-rata amortization, credit events, early termination events, etc)

Content of the Discussion Paper

- Analysis of market developments and trends
- Rationale (business case)
- Criteria for STS synthetic securitisation
- Analysis of possible differentiated regulatory treatment
- Recommendations

MARKET DEVELOPMENTS

Data sources

Volume and investor base:

- IACPM: since 2008 to early 2019, 22 European banks, 244 balance sheet transactions

Historical performance:

- S&P: 5948 synthetic securitisation tranches of rated synthetic transactions in Europe (from 2008, mostly representative of the pre-crisis period)
- IACPM: 14 European banks, 70 transactions (from 2008 to early 2019 i.e. are representative of the post-crisis period)

Other:

- SRT transactions reported by competent authorities to BA on annual basis

Market developments and volume

Increasing volume:

- 244 balance sheet synthetic securitisations have been issued since 2008 up until end 2018.
- In 2018, 49 transactions have been initiated with a total volume of 105 billion EUR.
- Arbitrage deals have almost disappeared from the market.

Bilateral/private type of transactions:

- Private/bilateral type of transactions form the substantial majority of synthetic market, the market is now more divergent and less standardised, including with respect to core structural features
- 18.6% of distributed tranches of all the transactions were placed publicly, which only represents 1.55% of the total size of the transactions
- In contrast to pre-crisis period where the deals were relatively standardised under the requirements of the credit rating agencies

Placed risk: Changing structure:

- Following the crisis, originators have changed their involvement in the synthetic securitisation market to only place mezzanine/first loss tranches with investors.
- This reflects the change in motivation to engage in synthetics: regulatory capital management is no longer the sole motivation, and synthetic securitisation is also issued for credit risk and balance sheet management purposes under the current macro-economic and regulatory circumstances.

Geographical distribution of exposures:

- Majority of synthetic transactions contain exposures from different jurisdictions.

Market developments and volume – cont.

Originators:

- Mostly credit institutions, in particular large IRB banks
- SA banks are still rarely originating, recently some have entered synthetic transactions supported by EIB/EIF in the context of the EIB/EIF's European SMEs initiatives

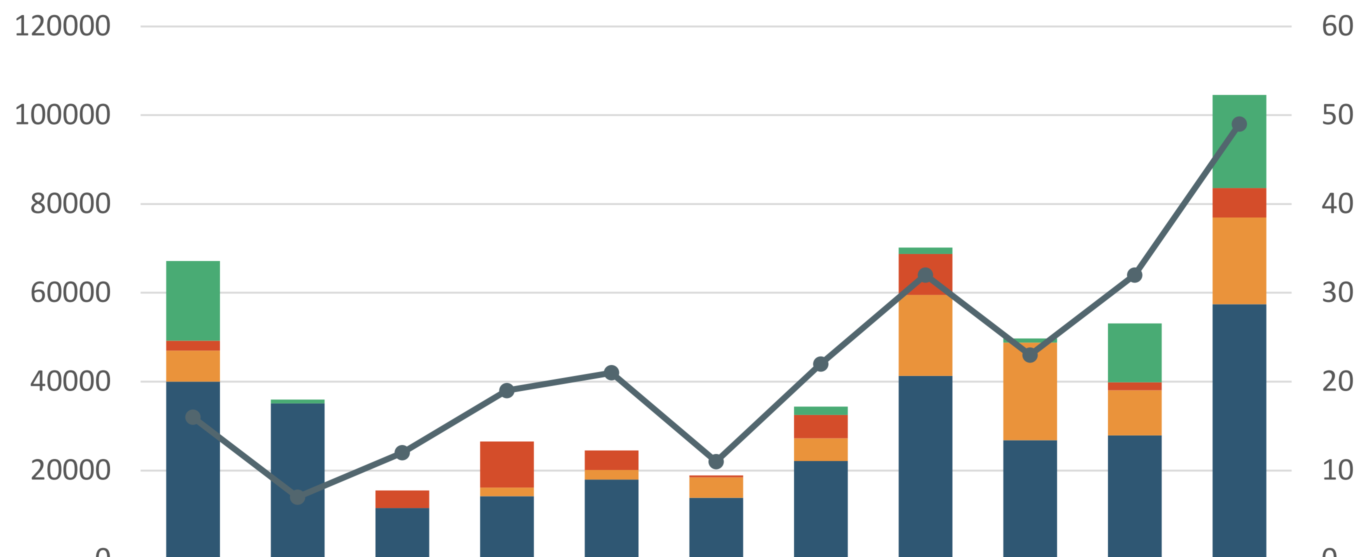
Investor base:

- Substantial majority of investors in synthetic securitisation are non-bank private entities, they mostly include hedge funds (39.6% in terms of volume of distributed tranches over 2008-2019), pension funds (30.6%) and asset managers (19.7%). Insurance companies only form a minority of the investor base (less than 1%).
- 90% of the credit protection provided by the private investors is funded credit protection.
- With respect to public investors, 4.5% of them are 0%-risk-weighted multilateral development banks. This includes EIB/EIF, which continue to be an important investor dominating the SME synthetic market.

Asset types:

- The predominant asset classes continue to be large corporates and SMEs, followed by trade finance.
- Trend in diversification of the asset classes, which now include also specialised lending (including infrastructure loans), commercial real estate, residential real estate, trade receivables, auto loans, micro loans and farming loans.
- Securitised assets also tend to be assets that are core to the bank business.
- Retail exposures, such as RMBS and consumer loans, are less common in synthetic securitisation.

Asset classes, volume (in EUR million), number of trades (source: IACPM)



	Year 2008	Year 2009	Year 2010	Year 2011	Year 2012	Year 2013	Year 2014	Year 2015	Year 2016	Year 2017	Year 2018
Other (RMBS, CMBS, etc)	17945	850	0	0	0	0	1876	1423	1000	13247	20902
Trade finance	2213	0	3983	10354	4412	443	5219	9289	0	1770	6639
SMEs	6988	0	0	2000	2123	4650	5170	18219	21932	10142	19580
Large corporates	40009	35123	11557	14173	17978	13831	22108	41276	26824	27926	57408
Number of trades	16	7	12	19	21	11	22	32	23	32	49

Performance

The **arbitrage synthetics** have performed **materially worse** than the **balance sheet** transactions.

The **balance sheet synthetics** have performed **better than traditional securitisations**, for all asset classes (SMEs CLOs, RMBS, CMBS, and other CLOs).

The **same applies for all the rating grades**. The default performance of balance sheet synthetics is better than that of the traditional securitisation, for all selected asset classes (all as of end 2018).

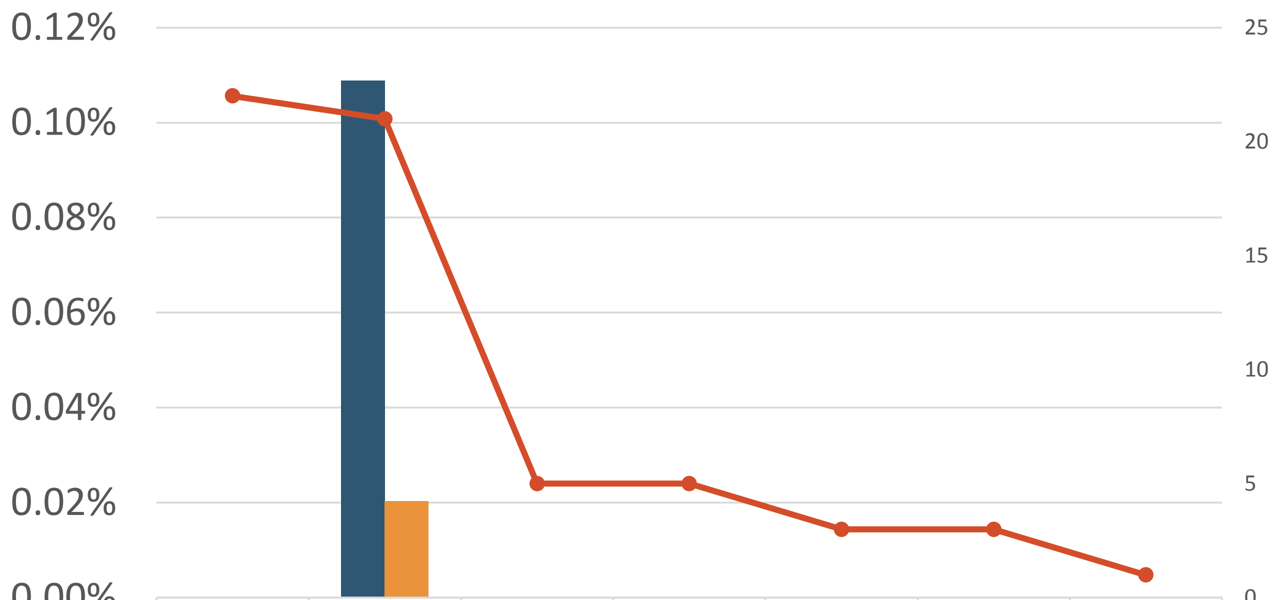
In terms of rating transition (i.e. using the average number of notches of rating transition over the life of the tranche as a measure of average credit quality change incurred by the tranche), **balance sheet synthetic tranches perform better than true sale tranches, with the exception of asset class of 'other CLOs'.**

There are **zero default and loss rates on senior tranche, on a significant majority of reported transactions and asset classes**. This is with the exception of SMEs, where the average annual default rate on 21 reported transactions is 0.11%, and annual loss rate is 0.02%.

The **default and loss rates are slightly higher when considering the whole portfolio** (i.e. all tranches and not senior tranches only), but still very low (with respect to annual default rates, the value is in every case below 1%). The default and loss rates are highest for SMEs, and followed by specialised lending. Average annual default rate for SMEs is 0.59%, while maximum reported amount is 1.77%.

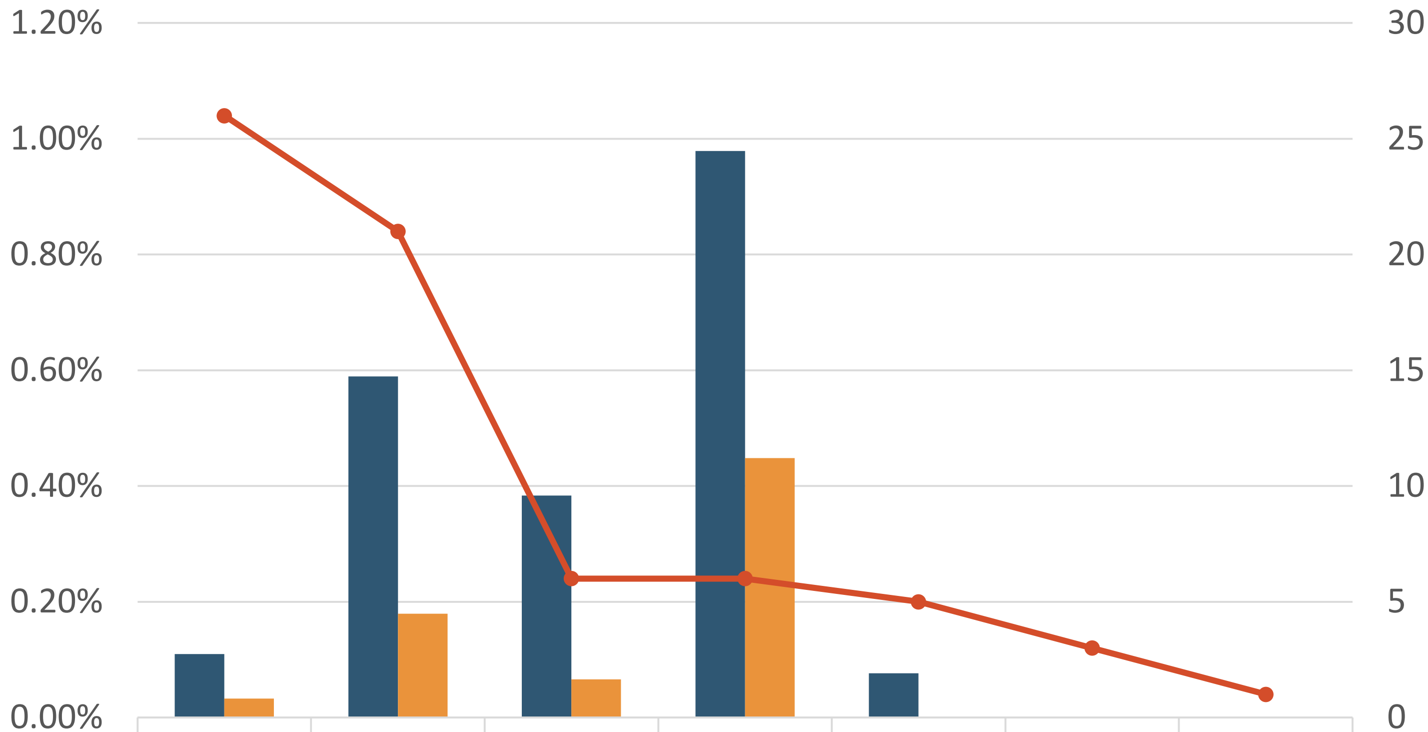
Both **default and loss rates are lower than those for comparable portfolios** (comparable portfolios are defined in the sample as portfolios from the same business division, or using the same rating model as the securitized pool).

Cumulative observed defaulted amount + loss amount at 31.12.2018 <u>on the senior tranche</u> divided by senior tranche size at inception and divided number of years elapsed (to measure realised annual default rate + realised annual loss rate, source: IACPM)



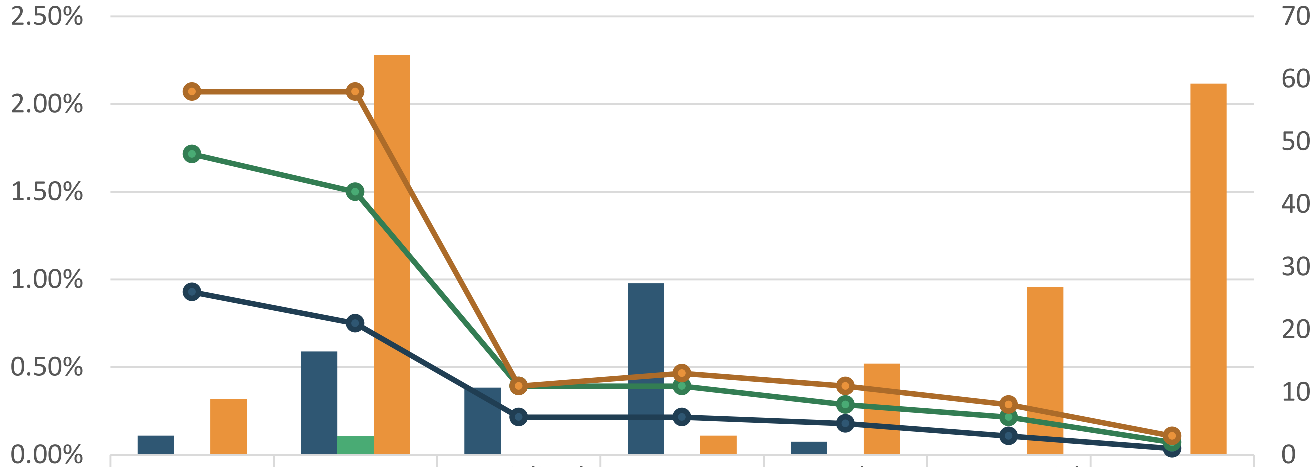
	Large corporates	SMEs	Specialised lending	Other	Trade finance	Commercial real estate	Auto loans
Annual defaulted rate	0.00%	0.11%	0.00%	0.00%	0.00%	0.00%	0.00%
Annual loss rate	0.00%	0.02%	0.00%	0.00%	0.00%	0.00%	0.00%
Number of trades	22	21	5	5	3	3	1

Cumulative observed defaulted amount + loss amount at 31.12.2018 on the securitized portfolio divided by Trade size at inception and divided number of years elapsed (to measure realised annual default rate, and realised annual loss rate, source: IACPM)



	Large corporates	SMEs	Specialised lending	Other	Trade finance	Commercial real estate	Auto loans
Annual defaulted rate	0.11%	0.59%	0.38%	0.98%	0.08%	0.00%	0.00%
Annual loss rate	0.03%	0.18%	0.07%	0.45%	0.00%	0.00%	0.00%
Number of trades	26	21	6	6	5	3	1

Default rate: Realised annual default rate, realised annual default rate on senior tranche and observed annual default rate on a comparable but broader portfolio of the bank, at 31.12.2018 (e.g. from the same business division, or using the same rating model as the securitized pool, source: IACPM)



	Large corporates	SMEs	Specialised lending	Other	Trade finance	Commercial real estate	Auto loans
Realised annual default rate	0.11%	0.59%	0.38%	0.98%	0.08%	0.00%	0.00%
Realised annual default rate on senior tranche	0.00%	0.11%	0.00%	0.00%	0.00%	0.00%	0.00%
Annual default rate on a comparable portfolio	0.32%	2.28%		0.11%	0.52%	0.96%	2.12%
N of trades (default rate on comparable)	10	16	0	2	3	2	1
N of trades (default rate on senior)	22	21	5	5	3	3	1
N of trades (defaut rate)	26	21	6	6	5	3	1

➢ ***Question 3: Do you agree with the analysis of the historical performance? Please provide any additional relevant information to complement the analysis.***

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RATIONALE (BUSINESS CASE)

Pros and cons of the development of STS synthetic product

Pros

Increased transparency of the product

Increasing relevance of the product in the context of ongoing regulatory developments

Increased relevance of the product due to some advantages compared to traditional securitisation

Further standardisation of the product and opening of the market for smaller originators and investors

Importance of regulatory endorsement for the revival of the market

Potential positive impact on the financial and capital markets, financial stability and on the real economy

Cons

STS balance sheet synthetic framework has not been developed at global level (IOSCO/BCBS)

Could be perceived as a high quality label by less sophisticated market players

Could lead to less issuance of traditional STS securitisations

Pros and cons of the introduction of more risk-sensitive regulatory treatment of the STS synthetic product

Pros	Cons
Stimulation of development of STS product; more in line with actual performance of balance sheet synthetics, more risk sensitive regulatory framework Overcoming constraints of current limited STS risk weight treatment of SME synthetic securitisations Ensuring regulatory playing field with the traditional securitisation Fuelling the potential positive impact of the synthetic securitisation on the financial markets and stability	Non-compliant with Basel STS: no balance sheet synthetic framework and no preferential treatment has been developed at global level (IOSCO/BCBS) Potential risks for the banking sector

Questions

- ***Question 4: Do you agree with the analysis of the rationale for the creation of the STS synthetic instrument? How useful and necessary is synthetic securitisation for the originator and the investor? What are the possible hurdles for further development of the market?***
- ***Question 5: Do you agree with the assessment of the reasons that could eventually support a preferential capital treatment?***
- ***Question 6: Please provide any additional relevant information on potential impact of the creation of the STS synthetic securitisation on (STS) traditional securitisation, and any other information to complement the analysis.***

CRITERIA FOR STS SYNTHETIC SECURITISATION

STS criteria for balance sheet synthetics

Additional objective as compared to STS criteria for true sale :

designed to ensure the protection of both the originators and investors

STS criteria

Criteria for STS traditional securitisation:

When not workable eliminated, otherwise adapted to synthetics

- Simplicity
- Standartisation
- Transparency

New criteria:

Counterparty credit risk

Structural features

Definition of balance sheet securitisation

- Credit events
- Credit protection payments
- Credit protection payments following the close out/final settlement at the final legal maturity of the credit protection agreement
- Credit protection premiums
- Verification agent
- Early termination events
- Excess spread
- Eligible credit protection agreement, counterparties and collateral

Simplicity

Synthetic securitisation	Comparison with criteria for traditional (non-ABCP) securitisation (references to Articles in Securitisation Regulation)
Criterion 1: Balance sheet synthetic securitisation, credit risk mitigation	Replacement of the criterion on true sale/assignment/assignment at later stage, clawback provisions, representations and warranties on enforcement of true sale (Art. 20(1) – (5) of the Securitisation Regulation) – with definition of balance sheet synthetics and requirement to ensure robustness of credit protection contract (credit risk mitigation criteria)
Criterion 2: Representations and warranties	Adaptation of the the criterion on representations and warranties (Art. 20(6): extension of the required representations and warranties and adaptation of their objective and content
Criterion 3: Eligibility criteria, no active portfolio management	Adaptation of the criterion on eligibility criteria, no active portfolio management (Art. 20(7)): adaptation of allowed portfolio management techniques, inclusion of additional conditions for removal of the underlying exposures in securitisation
Criterion 4: Homogeneity, enforceable obligations, full recourse to obligors, period payment streams	Similar to criterion on homogeneity, enforceable obligations, full recourse to obligor, periodic payment streams, (Art. 20(8))
Criterion 5: No transferable securities	Similar to criterion on transferable securities (Art. 20(8))
Criterion 6: No resecuritisation	Similar to criterion on no resecuritisation (Art. 20(9))
Criterion 7: Underwriting standards and material changes thereto	Adaptation of the criterion on underwriting standards and material changes thereto (Art. 20(10): additional clarification with respect to the types of eligible obligors and with respect to the underwriting of the underlying exposures
Criterion 8: Self-certified loans	Similar criterion on self-certified loans (Art. 20(10))
Criterion 9: Borrower's creditworthiness	Similar to criterion on borrower's creditworthiness (Art. 20(10))
Criterion 10: Originator's expertise	Similar to criterion on originator's expertise (Art. 20(10))
Criterion 11: No defaulted exposures or exposures subject to outstanding disputes	Similar to criterion on no defaulted exposures (Art. 20(11))
Criterion 12: At least one payment made	Similar to criterion on at least one payment made (Art. 20(12))
Criterion 13: No embedded maturity transformation	Similar to criterion on no predominant dependence on the sale of assets (Art. 20(13))

Standardisation

Synthetic securitisation	Comparison with criteria for traditional (non-ABCP) securitisation (references to Articles in Securitisation Regulation)
Criterion 14: Risk retention requirements	Similar to criterion on risk retention requirements (Art. 21(1))
Criterion 15: Appropriate mitigation of interest rate and currency risks	Adaptation of the criterion on appropriate mitigation of interest rate and currency risks (Art. 21(2)): to further specify measures for appropriate mitigation of interest rate and currency risks, adapted to synthetic securitisation
Criterion 16: Referenced interest payments	Similar to criterion on referenced interest payments (Art. 21(3))
Criterion 17: Requirements after enforcement/acceleration notice	Adaptation of the criterion on requirements after enforcement/acceleration notice (Art. 21(4)): adapted to reflect that not all synthetic securitisations use SSPE
Criterion 18: Allocation of losses and amortisation of tranches	Adaptation of the criterion on requirements for non-sequential priority of payments (Art. 21(5)): adapted with additional requirements for pro rata amortisation and allocation of losses
Criterion 19: Early amortisation provisions/triggers for termination of the revolving period	Adaptation of the criterion on early amortisation provisions/triggers for termination of the revolving period (Art. 21(6)): adapted with requirements for early amortisation only in the case of the use of an SSPE
Criterion 20: Transaction documentation	Adaptation of the criterion on transaction documentation (Art. 21(7)): with additional requirements for servicing standards and procedures
Criterion 21: Servicer's expertise	Similar to criterion on servicer's expertise (Art. 21(8))
Criterion 22: Reference register	Replacement of the criterion on definitions, remedies in the transaction documentation (Art. 21(9)): requirements for the transaction documentation to specify payment conditions is covered in separate criteria
Criterion 23: Timely resolution of conflicts between investors	Similar to criterion on timely resolution of conflicts between investors (Art. 21(10))

Transparency

Synthetic securitisation	Comparison with criteria for traditional (non-ABCP) securitisation (references to Articles in Securitisation Regulation)
Criterion 24: Data on historical default and loss performance	Similar to criterion on data on historical default and loss performance (Art. 22(1))
Criterion 25: External verification of the sample	Similar to criterion on external verification of the sample (Art. 22(2))
Criterion 26: Liability cash flow model	Similar to criterion on liability cash flow model (Art. 22(3))
Criterion 27: Environmental performance of assets	Similar to criterion on environmental performance of assets (Art. 22(4))
Criterion 28: Compliance with transparency requirements	Similar to criterion on compliance with transparency requirements (Art. 22(5))

Questions

- ***Question 7: Do you agree with the criteria on simplicity? Please provide comments on their technical applicability and relevance for synthetic securitisation.***
- ***Question 8: Do you agree with the criteria on standardisation? Please provide comments on their technical applicability and relevance for synthetic securitisation.***
- ***Question 9: Do you agree with the criteria on transparency? Please provide comments on their technical applicability and relevance for synthetic securitisation.***

Credit events

- At least the following credit events to be covered:
  - **Failure to pay of the underlying obligor**, as defined in Article 178 (1)(b) of the CRR;
  - **Bankruptcy of the underlying obligor**, as defined in Article 178 (3)(e) and (f) of the CRR;
  - **Restructuring of the underlying exposure**, as defined in Article 178(3) (d) of the CRR.
- Credit events should be clearly documented
- Forbearance measures should not preclude the trigger of credit events

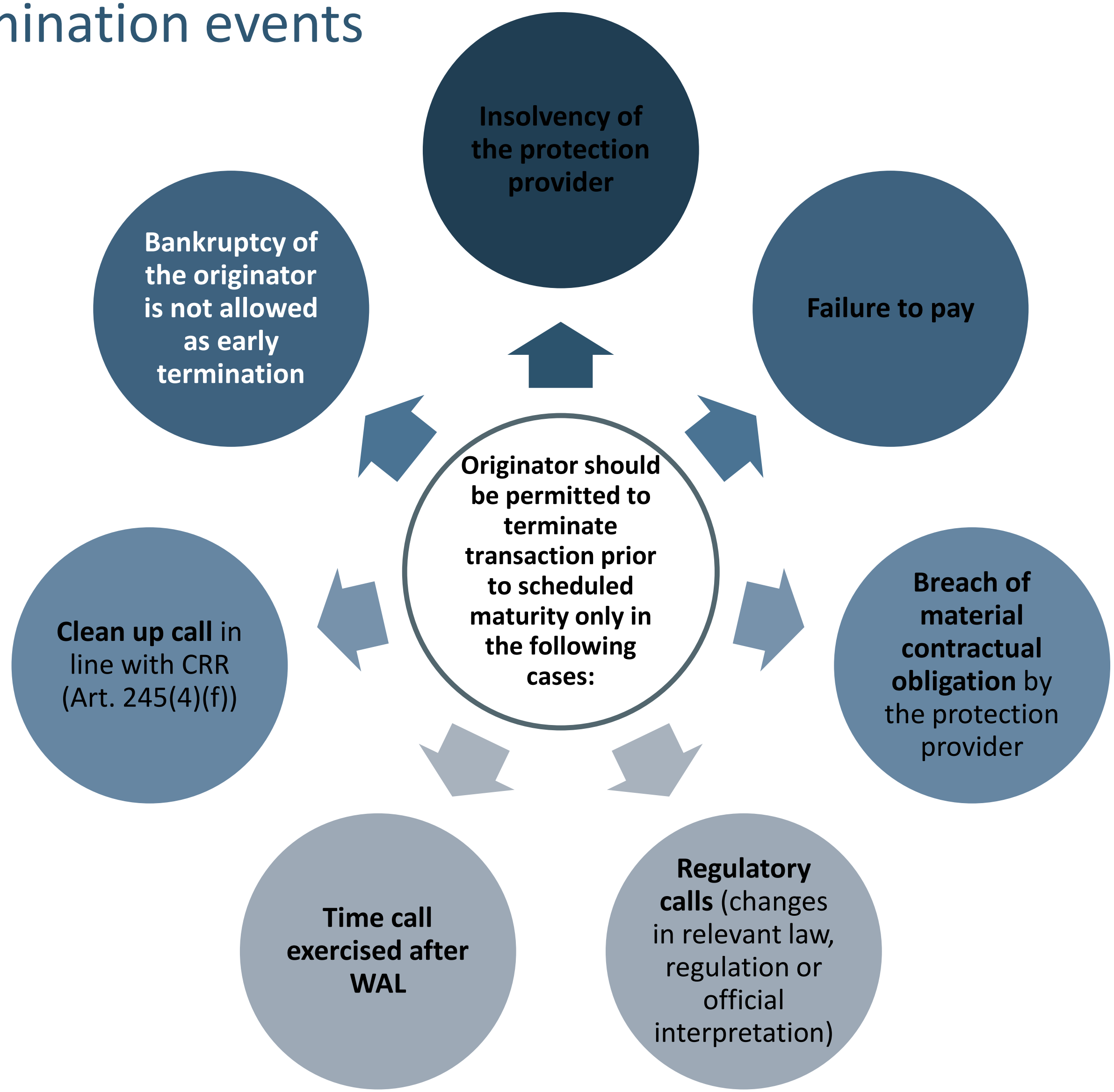
Credit protection payments

Should be calculated based on the **actual realised loss** suffered by the originator

Interim credit protection payment should be made 6 months after credit event (at the level or impairment or LGD)

Credit protection payments **following the close out/final settlement** at the final legal maturity of the credit protection agreement: on the basis of the actual loss suffered by the originator and recorded by the originator in its financial statements at that time.

Early termination events



Synthetic excess spread

No commitment to any amount of excess spread should be allowed for STS

Credit protection premiums

Should be **contingent premiums, i.e.**

no guaranteed premiums, upfront premium payments, rebate mechanisms or other mechanisms that may avoid or reduce the actual allocation of losses to the investors or return part of the paid premiums to the originator after the maturity of the transaction

Verification agent

A **third party independent verification agent** should be appointed by the originator at the outset of the transaction, in order to verify, at a minimum, the following points for each of the underlying exposures in relation to which a credit event notice was given:

- that **the credit event oc**curred in accordance with terms of the credit protection agreement;
- that the **underlying exposure was included in the securitisation** at the time of the occurrence of the relevant credit event;
- that the underlying **exposure met the eligibility criteria,** at the time of inclusion in the reference portfolio;
- that where an underlying exposure has been added as result of a replenishment, such replenishment complied with the **replenishment conditions;**
- the **accuracy of the final loss amount work out procedure,** also in relation to the losses registered in the profit and loss statement by the originator;
- that at the time where the final protection payment is made, **the allocation of losses to investors** in relation to the underlying exposures has been conducted correctly.
- Verification **may be performed on a sample**

Synthetic-specific requirements (cont).

Eligible credit protection agreement, counterparties and collateral

Allowed credit protection agreements:

- **Guarantee by 0% risk weighted supranational entities**
- **Guarantee benefiting from a counter-guarantee**
- Guarantees or credit derivative when **collateralised by high quality collateral** in one of the following forms:
  - **0% risk weighted debt securities**, held in a trust or entity set up for the sole purpose of holding securities whose notional value takes into account **clearly determined and conservative haircuts** to appropriately mitigate market and other risks, and which have a **short remaining maturity of maximum 3 months**, and under **robust custody arrangements**,
  - **Cash held with a third party credit institution** with a sufficient credit quality standing
  - **Additional requirements for collateral**
- The originator should obtain an **opinion from a qualified legal counsel** confirming the enforceability of the credit protection in all relevant jurisdictions.

Questions

- ***Question 10: Do you agree with the specific criteria for synthetic securitisation?***

- ***Question 11: Do you agree with the criterion 36 on eligible credit protection agreement, counterparties and collateral? Please provide any relevant information on the type of credit protection and different collateral arrangements used in market practice and their pros and cons for the protection of the originator and the investor.***

- ***Question 12: Please provide suggestions for any other specific criteria that should be introduced as part of the STS framework for simple, transparent and standardised securitisation.***

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Framework for a differentiated regulatory treatment of STS synthetic securitisation

Framework for a differentiated regulatory treatment of STS synthetic securitisation

No recommendations

… instead, question seeking stakeholders' input about the possibility of its introduction, potential impact, level playing field and other considerations …

… and analysis of arguments in favour/against the preferential capital treatment

Summary of the arguments/analysis

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Supporting arguments

- Technical feasibility of the creation of STS synthetic securitisation product
- Solid rationale (business case) for the STS synthetic product
- Market characteristics, trends and developments
- Good performance of the synthetic securitisation post crisis
- Level playing field/consistency with STS traditional framework
- Overcoming constraints of current limited STS risk weight treatment of SME synthetics
- Fuelling the positive impact of the (STS) synthetic securitisation on the financial markets and stability

Arguments against

- Non-compliance with Basel
- Limitations of data (e.g. not reflective of the full economic cycle)
- Very limited experience with the STS traditional framework so far
- Potential risks for the banking sector

Questions

- ***Question 13: Do you see a justification for possible introduction of a differentiated regulatory treatment of STS synthetic securitisation? If yes, what should be the scope of such treatment and how should it be structured - for example only senior tranche, only for originator banks or more limited/wider?***
- ***Question 14: What would be the impact if no differentiated regulatory treatment is introduced? In that case, is the introduction of the STS product without preferential treatment relevant for the market?***
- ***Question 15: What would be the impact of potential differentiated regulatory treatment from level playing perspective with regard to third countries where STS framework has not been introduced?***
- ***Question 16: Should a separate explicit recommendation be included in the Recommendations section on whether or not such treatment should be introduced?***

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