



THE EBA REPORT ON SYNTHETIC SECURITISATION

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EBA

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Abbreviations

ABCP	Asset-backed commercial paper
ABS	Asset-backed security
BCBS	Basel Committee on Banking Supervision
BofAML	Bank of America Merrill Lynch
CBO	Collateralised bond obligation
CDO	Collateralised debt obligation
CDS	Credit default swap
CLN	Credit linked note
CLO	Collateralised loan obligation
CMBS	Commercial mortgage-backed security
CSO	Collateralised synthetic obligation
ECAI	External Credit Assessment Institutions
EIB	European Investment Bank
EIF	European Investment Fund
IACPM	International Association of Credit Portfolio Managers
IOSCO	International Organization of Securities Commissions
KfW	Kreditanstalt für Wiederaufbau (Reconstruction Credit Institute)
PCS	Prime Collateralised Securities
RMBS	Residential mortgage-backed security
S&P	Standard and Poor's

Executive summary

Following the publication of its report on a qualifying framework for traditional (true sale) securitisation, in July 2015, the EBA has initiated the analysis and market practice assessment of synthetic securitisation in Europe. Given the scarcity of publicly available data on synthetic securitisation issuance, performance and market practice in Europe, the EBA has engaged in discussion and the exchange of information and data with various key stakeholders, including issuers, investors and rating agencies.

On 30 September 2015 the Commission published a proposed CRR amendment, accompanying the proposal on securitisation regulation ('the proposal'), in which the preferential regulatory treatment for simple, transparent and standardised ('STS') securitisations is foreseen for senior tranches of small and medium-sized enterprise ('SME') portfolios retained by originator banks, provided that significant credit risk has been transferred to either a central bank, central government, multilateral development bank or international organisation that is 0% risk-weighted in accordance with the CRR.

The report illustrates the main specificities of the synthetic securitisation technique, including the wide range of existing practices to structure credit protection contracts used for synthetic securitisation. Furthermore, evidence collected and analysis carried out by the EBA, to date, support the overarching approach taken by the Commission's proposal, where the focus of the differentiated regulatory treatment is on balance sheet synthetic securitisation positions retained by originator banks. In addition the proposal does not extend to establishing a fully-fledged STS framework for synthetic securitisation applicable to investors and across asset types.

While arbitrage synthetic transactions have been structured in the past to be complex, highly dependent on market values, and have performed poorly in terms of historical defaults, synthetic transactions that are genuinely used by institutions to transfer the credit risk of their lending activity off-balance sheet, i.e. balance sheet synthetics, have performed relatively well. The investor base of this segment of the synthetic securitisation market mostly comprises non-bank entities, such as hedge funds, asset managers and pension funds, which act as sophisticated investors and carry out in-depth due diligence analysis that involves exchanging detailed information with originator institutions on a bilateral basis. Whereas the prudential treatment of positions retained by originator institutions is a key element shaping the supply side of this market, the prudential treatment of investor positions is less of a relevant factor, given the nature and composition of the investor base. Furthermore, the objectives of a fully-fledged 'qualifying' framework, which involves assisting the securitisation investor base in the due-diligence of securitisation investments and removing the stigma of complexity and riskiness, which investors attached to the securitisation market as a whole following the financial crisis are less applicable to this segment of the market.

The analysis and evidence collected also support limiting the scope of the qualifying treatment to senior positions and to SME exposures at this stage. While there is wider evidence of zero defaults in relation to highly rated synthetic tranches of SME exposures, data available for other asset classes is less conclusive. In addition, not enough information is available to assess the performance and characteristics of non-senior tranches in synthetic transactions. The Commission proposals and subsequent Council general approach focus on balance-sheet synthetics via financial guarantees provided by 0% risk weighted entities; this scope is supported by EBA conclusions. A substantial widening of the scope to cover for an STS synthetic securitisation framework would be too premature at this stage.

The EBA however notes that the Commission may already now consider specific technical amendments. In particular, as this report illustrates, eligibility for the treatment provided for in Article 270 of the proposal may be made conditional on a reviewed version of the STS criteria for traditional securitisation, where several provisions are amended or eliminated to fully reflect the specificities of the synthetic securitisation technique and the originator focus adopted by the proposal. This would allow originator banks to apply STS capital requirements on senior synthetic tranches of SME portfolios they decide to retain if certain conditions are met while not extending the preferential treatment to third party investors.

With particular focus on the credit protection mechanism, the report highlights that synthetic securitisation is typically structured to be either an unfunded or a fully funded credit protection arrangement. In the case of unfunded protection, the creditworthiness of the protection provider, -i.e. its public/private nature and credit quality steps-, determines the counterparty credit risk incurred by the institution receiving protection. In the case of fully cash-funded credit protection whereby cash, in particular, is deposited with the institution receiving protection credit protection is immediately accessible with no risk being incurred by the beneficiary. The CRR acknowledges this by imposing a 0% risk weight on cash received to fund credit protection.

For these reasons the report advises the Commission to consider a modification of the proposal so as to extend eligibility to fully cash-funded credit protection provided by private investors in the form of cash deposited with the originator institution provided that specific criteria are fulfilled. It should be noted that fully cash-funded credit protection represents more than 90% of the issuance volumes surveyed by the EBA in relation to the period 2008-2014. These transactions are not eligible under the Commission's proposal.

1. Synthetic securitisation

1. Synthetic securitisation transfers the credit risk of a portfolio of exposures by means of a credit protection agreement, without transferring the ownership of the securitised 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 exposures is the protection buyer whereas the guarantor or counterparty in the credit derivative is the protection seller.
2. The CRR provides a definition of synthetic securitisation as reported in Box 1 below:

Box 1

Definition of synthetic securitisation as per Article 242(11) of the CRR

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.

3. While synthetic securitisation and traditional (i.e. 'true sale') securitisation may not fundamentally differ in terms of the nature of the underlying assets, risk tranching and capital (waterfall) structures, they use two different ways of transferring risk from the originator to the investor. While traditional securitisation realises this transfer by transferring the actual underlying exposures and their ownership to a securitisation special purpose entity (SSPE), synthetic securitisation realises the risk transfer by means of a credit protection contract between the originator and the investor, leaving the underlying exposures in the ownership of the originator and on its balance sheet. In synthetic securitisation, therefore, the actual extent of risk transfer depends not only on the capital structure of the transaction (i.e. the tranching), and on potential mechanisms of support from the originator (as it is the case in traditional securitisation), but also on the features of the credit protection contract on which the originator and investor agree, and on the creditworthiness of the investor.
4. Financial guarantors (in the case of financial guarantees) or swap counterparties (in the case of credit derivatives) agree to make good the losses suffered by the owner of the reference assets, up to a pre-agreed maximum amount that is the invested amount, if a credit event (e.g. a failure to pay by an obligor) occurs in relation to those assets. In return, the owner of the securitised exposures agrees to pay the financial guarantor or the swap counterparty a premium/fee based on the perceived probability of credit events occurring on the securitised exposures. As a result the financial guarantor or the swap counterparty gain exposure to the credit risk attached to the securitised exposures without title or any rights in these assets passing on to them.
5. Synthetic securitisation can be structured in many different ways depending on various factors. A major distinction arises with respect to the objectives of the transaction, where two

main types of synthetic securitisations can be identified: **balance sheet** synthetic transactions and **arbitrage** synthetic transactions.

1.1 Balance sheet synthetic transactions

6. 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 pool 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 hedge funds, pension funds, asset managers, insurance companies and other credit institutions.
7. From an originator's perspective, credit risk management and the related regulatory capital relief are the main objectives of balance sheet synthetic transactions. As part of their 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 the senior tranche of the same portfolio, which is typically, and by far, the largest of the tranches (e.g. 70%-80% of the securitised portfolio). Unlike traditional securitisation, synthetic securitisation does not provide the originator with funding.¹
8. Originators may be incentivised to use synthetic rather than traditional 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 effecting the transfer of ownership of the securitised exposures (e.g. exposures to SME obligors). 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, while some funded synthetic transactions set up an SSPE for the issuance of notes (i.e. credit-linked notes (CLNs)), an SSPE is not required at all within unfunded synthetic transactions. For these reasons market participants consider securitisation structures less burdensome and costly from an administrative perspective as well as less risky from a legal and operational point of view.
9. The counterparty credit risk potentially arising in the credit protection contract is the only element of complexity, from a transaction structure perspective, that is specific to synthetic securitisation (see the subsection on counterparty credit risk in Chapter 4). Counterparty credit risk may arise for the originator of the transaction (the protection buyer) due to the risk of default (or other events) in relation to the investor (the protection seller), resulting in the lack of credit protection. Counterparty credit risk may also arise for the investor (protection seller) due to the risk of default (or other events) in relation to the originator, resulting in missed

¹ Even when credit protection is fully funded by the protection provider in the form of cash (see Chapter 3), the cash collateral is not used for funding the securitised exposures and, net of the realised losses covered according to the protection contract, it has to be returned to investors at the termination or early-termination of the credit protection contract.

premium/fee payments by the originator and, where applicable, the loss of collateral posted by the investor to the originator or to a third party to fund the credit protection.

10. From a regulatory/supervisory perspective, compared to traditional securitisation, synthetic 'balance sheet' securitisation exposes the investor (protection provider) to the pure credit risk of the securitised exposures. In particular, risks stemming from the cash flow profile of the securitisation, such as pre-payment risk and interest risk, are less relevant for the investor's position, as the cash flows from the securitised exposures are not passed on to investors (i.e. they are not used to pay the CDS premium/guarantee fee payments owed to the investors). In addition, the legal risks relating to the transfer of ownership and segregation of the securitised exposures (claw back risk etc.) are not applicable within the synthetic securitisation environment.
11. The significant risk transfer (SRT) assessment, which is the assessment of whether the regulatory capital relief claimed by the originator is commensurate with the credit risk effectively being transferred to the investor, plays a crucial role in the case of synthetic securitisation, as synthetic transactions are always carried out for internal risk transfers and, in most cases, for SRT purposes (no funding objectives). As for traditional securitisation, this regulatory aspect is dealt with by the SRT rules in Article 244, as well as by the related EBA Guidelines.²
12. In addition to the SRT issue, it should be kept in mind that synthetic securitisation introduces leverage into the originator's balance sheet, as capital requirements are reduced and the securitised exposures remain on balance-sheet. The leverage ratio regulation, introduced with the CRR, addresses and mitigates the risk of excessive leverage, including the component of that risk that stems from synthetic securitisation.

1.2 Arbitrage synthetic transactions

13. The main objective of arbitrage synthetic securitisation (which is mainly CDOs, also called CSOs) is to arbitrage 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. Arbitrage synthetic securitisations are usually investor- and/or asset manager-driven and are structured to achieve a desired portfolio profile in terms of the seniority, rating and return desired by investors. Credit institutions usually arrange these transactions after being solicited by investors, who choose most conditions, such as the names to be included in the portfolio, tranche subordination and tranche size.
14. In some of these transactions credit institutions are not involved as originators, i.e. they do not own the securitised exposures, nor are they involved as investors. Instead, they are hired by asset managers or investors to arrange and tailor-make the transactions. The interest at stake

²<https://www.eba.europa.eu/documents/10180/749215/EBA-GL-2014-5+Guidelines+on+Significant+Risk+Transfer.pdf> (published in July 2014).

for the arranging credit institution is represented by administration fees, whereas the credit and market risks arising in the transaction are borne by the protection buyer and the protection seller that the arranger finds on the market. However, in order to maximise the bespoke and investor-oriented nature of synthetic CDOs, starting from 2003,³ the market has seen the expansion of the so-called single-tranche synthetic CDOs, whereby an arranger credit institution only sells a bespoke CDO tranche to an investor, typically a mezzanine tranche. In this case, the credit institution becomes the credit protection buyer (direct counterparty) in the CDS contract it has sold to the investor, and hence becomes exposed to the volatility risk of credit spreads in the portfolio of reference credits (market risk) and to the risk of default of the reference credits. In principle, the arranger credit institution should hedge these risks by taking opposite positions on the market. Historically, however, the structuring of single-tranche synthetic CDOs has left credit institutions with substantial open counterparty positions that have led to losses.

15. 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 exposures.

³ According to Standard and Poor's 90% of the synthetic CDOs issued in 2003 and 2004 were of the single-tranche type.

2. Market overview

16. Systematic data on market developments and the historical performance of synthetic securitisations in Europe is not available. Issuance data in this chapter is based on information published by BofAML on 14 June 2015, as well as on a voluntary data collection exercise carried out by the EBA in cooperation with IACPM. Data on historical performance was provided by S&P and by the KfW.

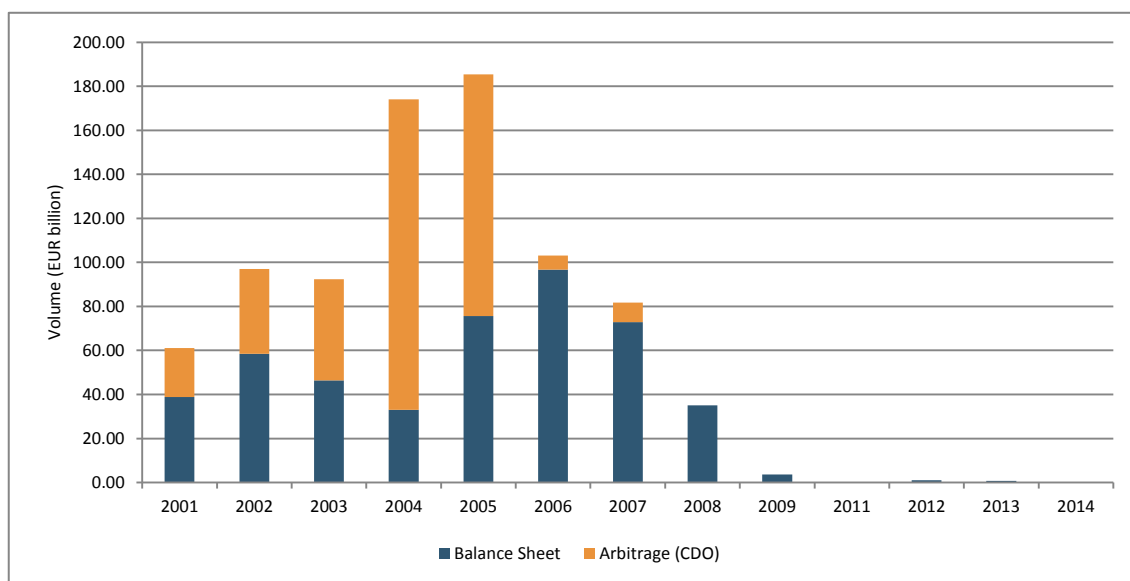
2.1 Market issuance

17. According to data collected from BofAML, reported in Figure 1 below, European synthetic securitisation issuance peaked during 2004-2005, with volumes above EUR 180 billion and with a majority of the transactions being of the (CDO) arbitrage type. Issuance almost halved in 2006 and then gradually reached almost zero levels, with issuance of arbitrage transactions decreasing more rapidly than issuance of 'balance sheet' transactions. The increased volumes of issuance prior to 2007 also reflect the transition between Basel 1 and Basel 2 (CRD entered into force in January 2007 and introduced internal model approaches to capital requirements), whereby originating institutions typically placed the super senior tranches⁴ of synthetic transactions (and hence the largest tranches of the transaction in terms of volumes) with monoline insurers and/or highly rated investor institutions, to, inter alia, smooth the expected increase in regulatory capital. Following the 2007-2009 crash of the securitisation market, with monoline insurers and other relevant parties in the investor base withdrawing from the market, institutions have started engaging in retained securitisation transactions in the true sale market in order to post the securitisation notes in repo transactions with central banks in exchange for liquidity. In a materially different funding environment, banks have changed their involvement in the synthetic securitisation market to only place, to the extent possible, mezzanine tranches (typically, a smaller portion of the transaction's volume and hence the very low aggregate volumes of issuance) with investors, with the aim of achieving regulatory capital relief and de-risking.

18. The EBA report on qualifying securitisation has illustrated similar subdued dynamics for true sale (term) securitisation after 2008 (see Chapter 1 of that report) and has elaborated on several impediments underpinning the post-crisis decline of the securitisation market as a whole (see Chapter 3 of that report).

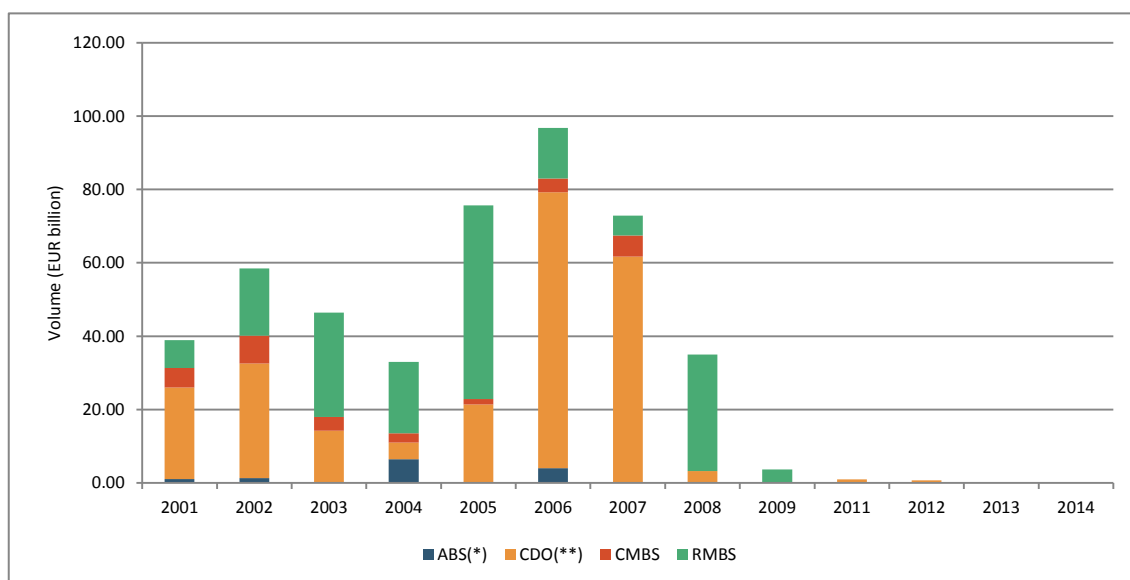
⁴ See Chapter 3, 'Types of synthetic balancesheet transactions'.

Figure 1: European synthetic securitisation issuance: balancesheet vs. arbitrage transactions (source: BofAML)



19. The balance sheet segment of the synthetic market was mainly dominated by the RMBS and the CLOs (balancesheet type of CDOs), with minor volumes of CMBS and ABS products (see Figure 2 below). Within the balance sheet CDOs, CLOs and SME exposures were the dominant asset classes.

Figure 2: European synthetic securitisation issuance: balancesheet transactions by asset class (source: BofAML)

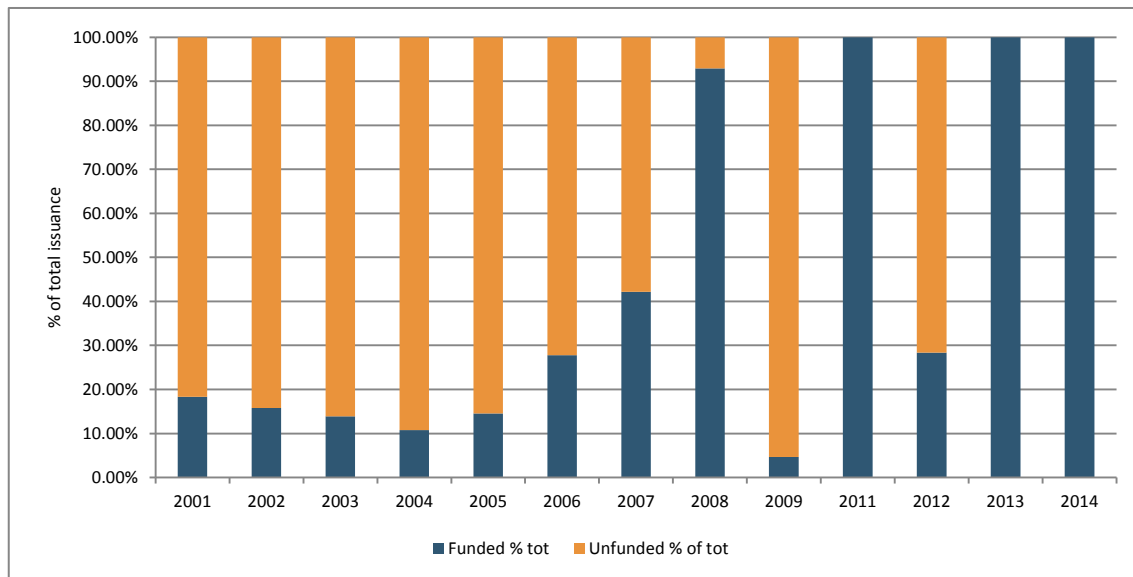


(*) Mostly includes consumer finance loans.

(**) Includes SME and corporate balance sheet deals, CSOs and some arbitrage deals.

20. It should be noted that unfunded credit protection represented the prevailing credit protection mechanism until 2008, at which point, at the very low levels of issuance illustrated above, the funded protection mechanism became dominant (see Figure 3 below).

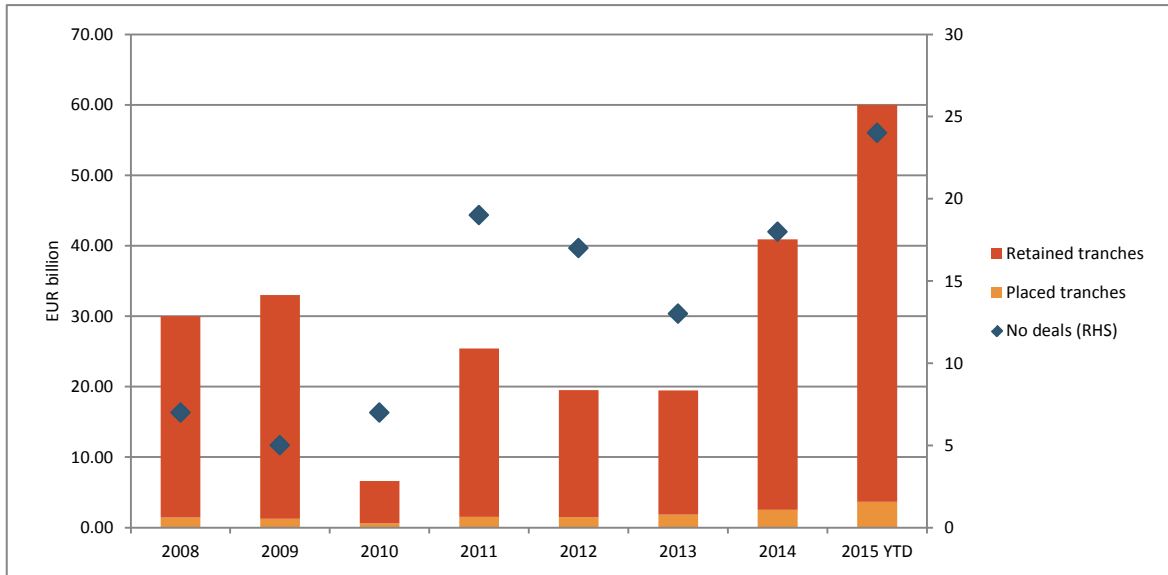
Figure 3: European synthetic securitisation issuance: funded vs. unfunded credit protection (source: BofAML)



21. Whereas data collected by BofAML likely captures the vast majority of synthetic securitisation issuance in the pre-crisis period (as most transactions in that period being rated by credit rating agencies, and, overall, more public information was available at that time), issuance of synthetic securitisation from 2008 onwards has mostly been bilateral and has not involved the activity of rating agencies. The EBA has engaged with the IACPM with the aim of collecting additional information on synthetic securitisation issuance, covering the period from 2008 to present. The issuance volumes reported in Figure 4 and Figure 5 stem from the activity of 12 large European issuers. These volumes should not be considered as an exhaustive representation of the current market activity. Rather they represent a lower bound estimate of synthetic securitisation issuance post-crisis.

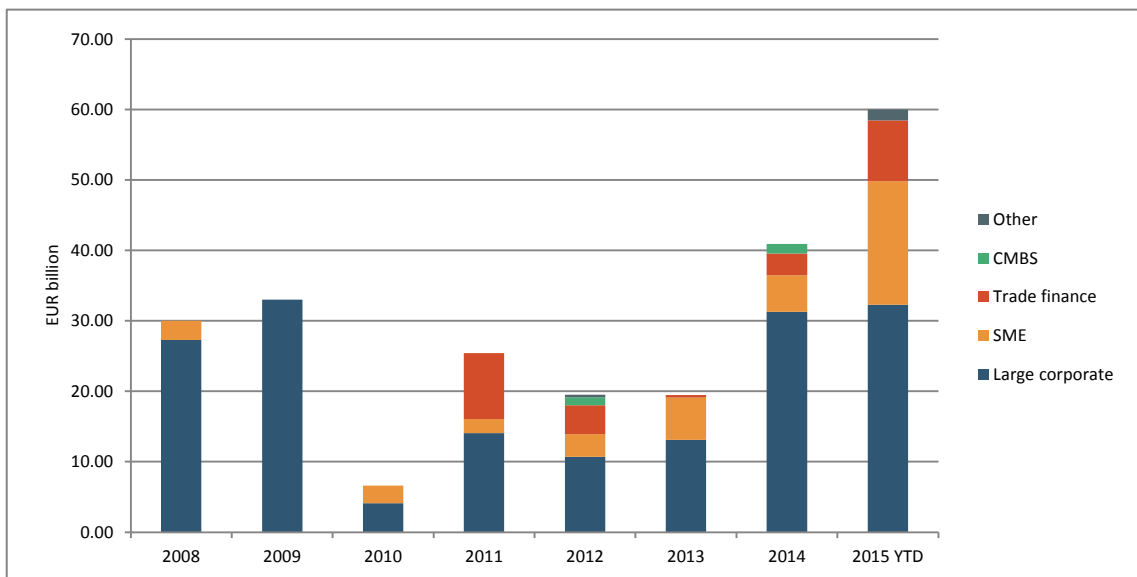
22. In particular, Figure 4 represents the total volume of securitised portfolios split into tranches retained by originators and tranches placed with investors to realise the (significant) risk transfer.

Figure 4: European synthetic securitisation issuance: retained and placed tranches (Source: The EBA voluntary data collection sample)



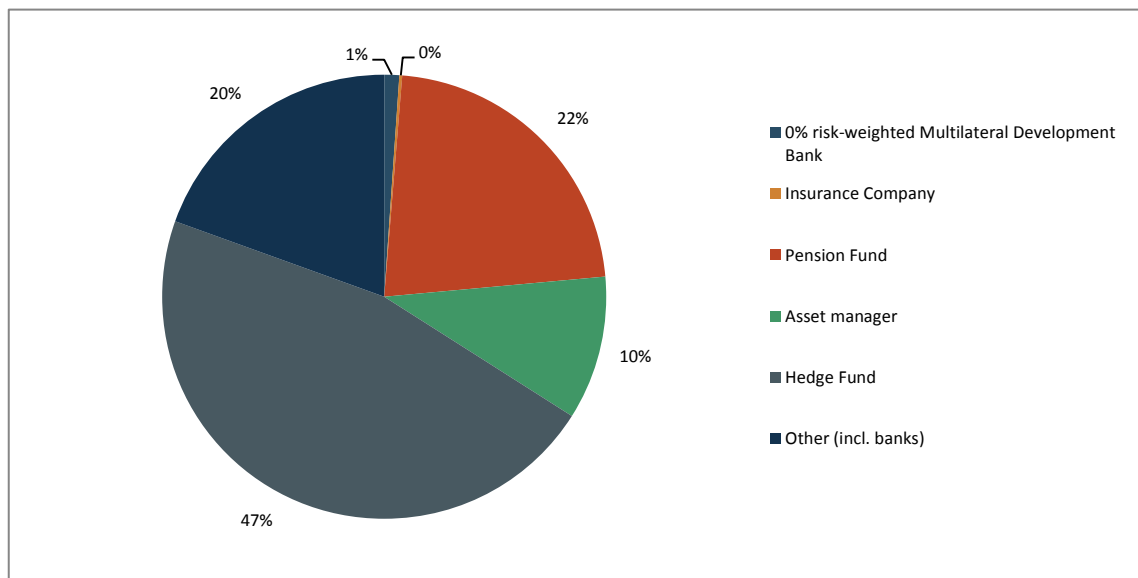
23. Figure 5 reports the same data focusing on the total volumes of securitised portfolios (retained tranches plus placed tranches) and provides the asset class break down.

Figure 5: European synthetic securitisation issuance: total securitised portfolios by asset class (source: The EBA voluntary data collection sample)



24. The investor base of synthetic securitisation in the same period comprises, for the vast majority, non-bank entities, as detailed in Figure 6 below. According to data reported by the issuers participating in the data collection exercise, more than 90% of credit protection provided by the investors indicated in Figure 6 is funded credit protection.

Figure 6: European synthetic securitisation investor base⁵ of placed tranches (source: The EBA voluntary data collection sample)



25. According to estimates elaborated by BofAML, the synthetic securitisation market in the US came to a halt in 2007 and has not recovered since. According to the BofAML analysis the US market was mostly made up of the arbitrage type, with most recurrent underlying exposures being mezzanine securitisation tranches and high-grade securitisation tranches (hence re-securitisation), investment grade bonds, CDOs (hence re-securitisation) and high-yield loans.

26. More recently, large synthetic securitisation operations have been put in place by Freddie Mac and Fannie Mae, the two US Government-sponsored entities (GSEs) that, in the past few years came to take about 60% of the whole US mortgage lending market on their balance sheet. Following the bailout of these entities by the US Government, the government itself established an overall risk transfer objective for these entities of about 75% of all the credit risk held on balancesheet. As of the end of 2014, the GSEs had issued approximately \$11 billion of CLNs (synthetic securitisation) to market investors, transferring the first loss risk (e.g. up to 4.5% of first losses net of a very thin tranche retained by the GSE) of the mortgage pool they hold on balance sheet. The overall first loss tranche was divided into notes of different seniority and placed mostly with money managers and hedge funds (the riskiest tranches), but also with banks and insurance companies (the less risky tranches).

Box 2

Definitions applicable to the market practice of synthetic securitisation

Collateralised Synthetic Obligation: a form of CDO that does not hold 'direct' exposures to credit risk such as loans (i.e.

⁵ The investor base reported here covers slightly more than 90% of the issuance volumes included in the EBA voluntary data collection sample, as investor base data was not available for certain issuers.

CLOs) or bonds (i.e. CBOs) but rather invests in CDSs or other non-cash instruments to gain exposure to an underlying portfolio.

Cash-flow vs. market value CDO: the performance of the cash-flow CDO and the principal and interest payments to note holders are mostly based on the cash flows attached to the collateral. As the cash flow from the collateral proves inadequate, payments to note holders become sequential according to the waterfall. In the case of market value CDO the performance of the CDO and the principal and interest payments to note holders are based on both the cash flows from the collateral as well as the sale (hence the market value) of that collateral.

Balance-sheet vs. arbitrage CDO: balance-sheet CDOs are used by institutions to transfer risk outside of their balance sheet. The main objective of arbitrage CDOs is to arbitrage between the (higher) spread received on underlying lower credit quality debt and the (lower) spread paid on the resulting structured and credit-enhanced CDO note.

2.2 Performance of synthetic securitisations

27. Data on historical loss and default performance is more difficult to gather for synthetic securitisation transactions than it is for true sale transactions, as most synthetic transactions are not public and are often unrated.

28. This section looks into the historical performance of synthetic securitisation transactions by focusing on the following aspects:

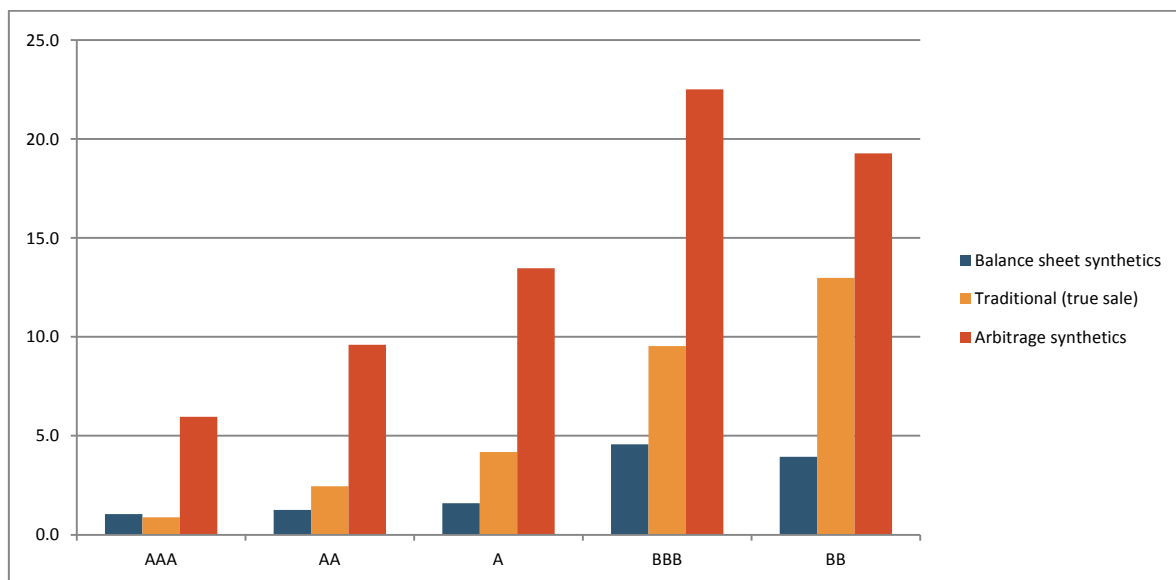
- a) A comparative analysis of the historical performance of arbitrage synthetic securitisation vs. balance-sheet synthetic securitisation;
- b) A comparative analysis of the historical performance of synthetic (balance sheet) vs. true-sale securitisation.

29. The comparative analysis is based on the historical performance of ratings issued by S&P. S&P issued most of its ratings on synthetic securitisation transactions between 2000 and 2008, with very few ratings also issued prior to 2000 and after 2008. The overall S&P sample used for the purposes of this analysis is made of 5952 synthetic securitisation tranches, where reflecting the composition of the European synthetic market (see previous section) a majority of the rated tranches belongs to the category of arbitrage synthetic securitisation. The main asset classes included within the balance sheet synthetic securitisation and traditional securitisation samples are RMBS, CMBS, SME CLOs and other CLOs.

30. Figure 7, below, compares balance sheet synthetics, arbitrage synthetics and true sale securitisations in terms of lifetime default rates⁶ of securitisation tranches, which have initially obtained an external rating by S&P.

⁶ The lifetime default rate measures the percentage (%) of tranches initially rated at a given rating level (e.g. 'AAA') that defaulted at any point in time during their lifetime.

Figure 7: Lifetime default rate (%): balance sheet synthetic tranches, arbitrage synthetic tranches, traditional tranches, per rating grade (source: S&P, as of 2014 and the EBA calculations)



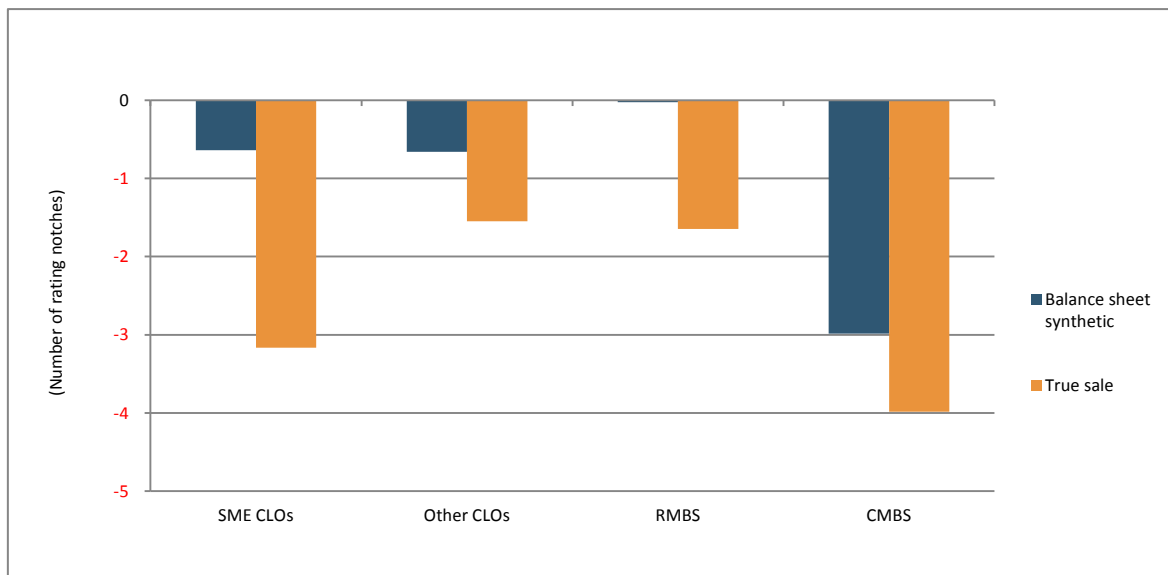
31. The S&P evidence suggests that:

- a) Arbitrage synthetics performed materially worse than both balance sheet transactions and traditional securitisation transactions;
- b) The default performance of balance sheet synthetics is comparable to that of traditional securitisations for high rating grades whereas for balance sheet synthetics is better for lower rating grades.

32. The evidence under point (b) above is broadly consistent across the different asset classes that enter the S&P sample, as reported in Figure 9 to Figure 12 in the annex to this report. The slightly better performance of traditional securitisations at the 'AAA' rating level reflects the specific case of the CMBS asset class (see Figure 11 in the annex to the report).

33. Figure 8 below compares balancesheet synthetic tranches to true-sale tranches rated by S&P per asset class, 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 tranches. Balancesheet synthetic tranches appear to perform better than true sale tranches across asset classes. This result broadly holds if the same metric of credit quality is investigated within each asset class on a rating grade level (i.e. AAA, AA, etc.).

Figure 8: Average change in credit quality (notches) synthetic securitisation vs. true-sale securitisation per asset class
(Source: S&P as of 2014)



34. Comparing (balancesheet) synthetic transactions with true sale transactions within a specific asset class and a specific jurisdiction is typically problematic due to sample size issues, as within jurisdictions and/or specific asset classes, there tends to be a bias towards one specific type of securitisation either the truesale or the synthetic one.

35. Germany is an exception, in that there are samples of tranches rated by S&P within the German RMBS and German SME CLO markets that take both the true-sale and synthetic format. Lifetime default data, as well as credit quality migration data confirm the better relative performance of balancesheet synthetic securitisation compared to true sale securitisation within the markets of German RMBS and German SME CLOs (see Table 1 in the annex to this report for the related S&P performance data).

36. Figure 18 and Figure 19 in the annex to this report illustrate portfolio loss performance data for the KfW PROMISE and PROVIDE transactions, which are synthetic securitisation transactions backed, respectively, by exposures to SMEs and residential mortgages mostly domiciled in Germany. The data only reflects the performance of the securitised exposures; hence it is not informative of the performance of the different tranches existing under the respective transactions. Lifetime cumulative losses in most of the RMBS and SME portfolios remain below 1%, with SME transactions reporting overall higher losses than RMBS transactions.

37. In reading the available evidence on historical performance, it should be taken into account that the type of underlying collateral, the vintage of the transaction and the business cycle conditions in the jurisdiction of issuance are factors, that in all likelihood, contribute to determining the better performance of balance sheet synthetics as pictured by the figures, while the transactions included in the traditional securitisation sample are more biased towards jurisdictions more severely hit by the crisis and/or lower quality underlying collateral.

Whereas accounting for these factors would likely reduce the extent to which balancesheet synthetics outperform traditional securitisation, no evidence exists to suggest that the performance result could be reverted in a consistent fashion. In this regard, rating agencies' descriptions of their approach to synthetic securitisation clarifies that, from a methodological perspective, no specific structural factor exists that justifies an ex ante expectation of worse performance of the synthetic securitisation instrument, as opposed to the traditional securitisation instrument, once the other mentioned risk drivers are accounted for.

2.3 Informal collection of evidence from market participants

38. As part of the collection of evidence conducted to inform this report, the EBA organised a round table discussion event with participants in the market of synthetic securitisation.

Performance of synthetic products

39. Both investors and issuers participating in the EBA round table on synthetic securitisation confirmed that arbitrage synthetic transactions performed significantly worse than balancesheet synthetic transactions. Moreover, in light of the substantially different rationales of the two types of synthetic transactions, all involved stakeholders agreed with such broad partition and with excluding arbitrage transactions from any type of regulatory recognition.

40. Investors highlighted that the performance of balance sheet synthetic transactions tends to align to, or to outperform, their expectations (at closing) and is consistent with the performance of the underlying portfolios. This is also confirmed by data that the EIF and KfW could share with the EBA, in which, cumulative loss and cumulative default figures, expected at closing, are in most cases higher than the realised figures.

Banks' interest at stake in synthetic securitisation

41. Credit institutions enter the current market of synthetic securitisation as originators (credit protection buyers) and not as investors (credit protection sellers). Banks engage in synthetic securitisation with the aim of transferring/managing the credit risk they hold on their balance sheet and, in the vast majority of cases, with the aim of receiving regulatory capital relief (i.e. a significant risk transfer objective). In this regard, the regulatory capital treatment of the risk that the originator bank retains on balance sheet (mostly the senior tranche of the securitised portfolio and a portion of the first loss tranche) is the key regulatory issue that institutions are keen to address, with a view to ensuring regulatory level playing field between traditional (true sale) and synthetic securitisation. In this context it should also be highlighted that originator institutions tend to be institutions applying the internal-ratings-based (IRB) approach to determine their capital requirements for credit risk.

42. The Annex to this report presents an example of the different extent of capital relief an originator bank would benefit from on its retained (synthetic) securitisation positions according to, respectively: i) the current CRR securitisation framework, ii) the BCBS revised securitisation framework (December 2014) and iii) the 'qualifying' re-calibration if extended

to originator's retained synthetic securitisation positions. The example is representative of a synthetic transaction which benefits from a supranational investor guarantee of the mezzanine tranche. While under the Basel 2014 framework the capital relief due to the synthetic securitisation would amount to 48.2% (i.e. the originator retaining the senior tranche and the junior tranche of the portfolio would obtain a capital reduction which amounts to 48.2% of the capital the bank would have to hold on the non-securitised portfolio of loans), the capital relief would increase to 54.9% if the originator was allowed to use 'qualifying' risk weights on its retained synthetic positions. It should be noted that the provided example is by no means exhaustive of the different potential outcomes of capital relief that can result when comparing the Basel 2014 framework with the 'qualifying' re-calibration, as different transaction structures would result in different outcomes.

Investor base of the synthetic securitisation market

43. The (mostly junior and mezzanine) credit risk transferred by originator banks tends to be taken on by non-bank investors. These include, but are not limited to, pension funds, insurance companies, hedge funds, sovereign funds, other specialised funds and public/supranational investors, such as the EIB/EIF group, the German KfW promotional bank and funds of local public entities counter-guaranteed by central governments. Therefore, the participation of banks within the investor base as well as the regulatory capital treatment of synthetic securitisations for banks as securitisation investors, are not key determinants of the demand for synthetic securitisation in the current market environment.

Standardisation of synthetic securitisation market practices

44. In a rather consistent fashion stakeholders highlight that while a variety of different transaction structures (e.g. SPPE issuing CLNs vs bilateral bank-investor CDS contracts or financial guarantees) and credit risk protection agreements are used in the market, certain fundamental aspects of synthetic risk transfer are common across all transactions and could benefit from some degree of standardisation. Some market participants highlighted that while standardising detailed aspects of the credit risk protection contract towards one specific practice may be at odds with proportionality, and may exclude widespread practices, allowing issuers and investors to choose among a set of alternative practices equally endorsed in the regulation may achieve a proportionate degree of standardisation. Stakeholders also highlighted that standardisation should take into account the different accounting, prudential and other regulatory regimes that different instruments of credit risk transfer (e.g. guarantees and CDS), are subject to.

Transparency

45. As a general point stakeholders highlight synthetic securitisation achieves a high degree of transparency, that albeit in a bilateral fashion (i.e. only between the issuer and the actual investor, which is the credit protection seller). Stakeholders also highlight that synthetic transactions are entered into with sophisticated investors, who make full use of the information they receive from originator banks to carry out in-depth due-diligence analysis

and, who, as appropriate, are in a position to request and obtain further and more detailed information from originators on the transactions they invest in.

3. Types of synthetic balancesheet transactions

46. As acknowledged by the CRR's definition of synthetic securitisation, the credit risk of exposures held on balancesheet by an institution can be transferred to third parties by means of two different mechanisms:

- a) Credit derivative instruments;
- b) Guarantees.

47. Credit risk transfer by means of credit derivative instruments can assume a funded, partially funded or unfunded format. Financial guarantees are unfunded forms of credit risk mitigation, whereas cash or collateral deposits constitute forms of funded credit risk mitigation. The following paragraphs elaborate on the above mentioned main types of credit risk transfer mechanisms.

3.1 Credit protection through credit derivatives

48. Where a **credit derivative instrument** is used to transfer the credit risk of a portfolio of reference exposures the funded or unfunded nature⁷ of the protection determines the following two types of transactions:

- a) Unfunded - CDS: the originator of the exposures, usually a bank, buys credit protection from a protection seller, usually another bank, an insurance company or SPV. Upon certain pre-determined credit events on the reference exposures (in the case of synthetic securitisation, this would be the securitised exposures), the protection buyer makes claims on the protection seller in exchange of regular premium payments. The credit risk of the reference exposures is, therefore, borne by the protection seller. The ability of the protection buyer to obtain credit risk protection, should credit events occur, depends on the creditworthiness of

⁷ In CRR language:

- Unfunded credit risk mitigation means a technique of credit risk mitigation where the reduction of the credit risk on the exposure of an institution derives from the obligation of a third party to pay an amount in the event of the default of the borrower or the occurrence of other specified credit events (e.g. financial guarantees, CDS);
- Funded credit risk mitigation means a technique of credit risk mitigation where the reduction of the credit risk on the exposure of an institution derives from the right of that institution, in the event of the default of the counterparty or on the occurrence of other specified credit events relating to the counterparty, to liquidate, or to obtain transfer or appropriation of, or to retain certain assets or amounts, or to reduce the amount of the exposure to, or to replace it with, the amount of the difference between the amount of the exposure and the amount of a claim on the institution (e.g. cash collateral, CLNs, etc.)

the protection buyer (i.e. counterparty credit risk exposure of the protection seller towards the protection buyer).

- b) **Funded –CLNs**: the credit risk of the reference exposures is transferred to investors via the issuance of CLNs. The notes are typically issued by an SPPE, which normally invests the proceeds from the sale of the notes in eligible investments (low-risk fixed income assets) and uses the returns from such investments, in addition to the protection premium payments received from the originator, to ensure that interest payments towards CLN holders are fulfilled. The cash proceeds are also used to repay the protection buyer upon occurrence of pre-determined credit events on the reference exposures. CLNs are partly written-off when losses on reference exposures occur. Due to the (pre-)funded nature of these transactions, the ability of the protection buyer to obtain credit risk protection, should credit events occur, does not depend on the creditworthiness of the protection buyer (i.e. no counterparty credit risk arises for the protection buyer towards the protection seller). Funded CDS contracts do not always take the form of CLNs issued by an SPV; funded CDSs can also be written bilaterally between the originator and investor, particularly in cases where the originator only places with investor one specific tranche of the portfolio (typically a first or second loss tranche). The latter transactions are often called **tranchéd cover transactions**.

49. An unfunded CDS structure is represented in Figure 13 in the annex. Funded and unfunded mechanisms can also coexist within an individual transaction, as illustrated in Figure 14 in the annex. In these cases, a 'super senior' tranche is represented by an unfunded CDS, which typically covers a large portion of the risk of the securitised portfolio and benefits from the credit enhancement provided by subordinated funded tranches (CLNs). The unfunded super senior tranche is usually placed with a highly rated credit institution, such as a (monoline) insurer or another entity whose creditworthiness is good enough to mitigate the counterparty credit risk. The advantage of this type of structure lies in the fact that the cost of issuing the super senior tranche is materially lower than the cost of issuing the subordinated funded CLNs.⁸

50. It should be noted that synthetic SME and RMBS transactions issued within the PROMISE and PROVIDE platforms set up by the German promotional bank, KfW, in Germany have typically taken the form of credit-linked notes issued on the capital markets by via special purpose vehicles (see Figure 18 and Figure 19 in annex to this report).

3.2 Credit protection through financial guarantees and/or cash collateral

⁸ For example, investors in the super senior note may be paid a premium for credit protection equal to 10 basis points, while investors in a mezzanine tranche may have to be paid an euribor interest rate plus a premium that ranges from 50 to 300 basis points, depending on the subordination of the mezzanine.

51. **Tranched cover transaction** is also the name given to widespread synthetic securitisation transactions that use **financial guarantees** (i.e. unfunded credit risk mitigation, as per CRR language) and/or **cash deposits** (funded credit risk mitigation instruments, as per CRR language) to transfer credit risk from protection buyers, usually banks, to protection sellers, typically supranational entities, national public sector entities and, albeit less often, private investors.
52. In these tranched cover transactions a portfolio of exposures is typically divided into two or three tranches where (albeit not as a general rule):
- a) The senior tranche is retained by the originator bank;
 - b) The mezzanine tranche is guaranteed by a credit protection seller;
 - c) The junior tranche is either fully retained by the originator or partly retained by the originator and partly 'covered' by cash collateral provided by an investor.
53. A recurrent form of financial guarantee on mezzanine tranches (i.e. second loss guarantee) is represented, in Europe, by the mezzanine financial guarantee facility offered by the EIB/EIF, although similar protection may also be provided by other protection sellers, including national public entities in different Member States. The EIB/EIF facility has exclusively focused on the securitisation of portfolios of SME loans, and has been operating since, at least, 2004.⁹
54. In certain tranched cover transactions, particularly at the junior tranche level, credit risk transfer takes the form of a cash deposit, rather than a financial guarantee. Figure 15 and Figure 16 in the annex represent two examples (by no means exhaustive examples of the market practice) of tranched cover transaction, including three and two tranches, where credit risk transfer occurs via either unfunded credit risk mitigation (financial guarantee) or a combination of unfunded and funded (cash collateral) credit risk mitigation, respectively.
55. According to preliminary discussions held by the EBA with various stakeholders, a vast majority of the originating institutions engaging in tranched cover transactions are IRB banks. In a typical transaction, provided that they meet the retention rules and pass the supervisory test of the SRT, IRB originators are allowed to use the supervisory formula of the CRR securitisation framework on the senior tranche of the portfolio, which is retained on balance sheet. Originators also gain regulatory capital benefit from credit risk mitigation on the tranches guaranteed by a financial guarantee and/or cash collateral. As shown in Figure 17 in the annex to this report (in the case of a mezzanine financial guarantee), the overall capital relief

⁹ In 2012, the EIB further created the SME Initiative, which is expected to increase its investment capacity into SME-backed ABSs, with a combination of investment in senior ABS cash tranches and mezzanine guarantee facilities (the latter implying synthetic risk transfer). The initiative, under the new Multiannual Financial Framework (MFF), will use not only the EIB funds but will also deploy European Structural Investment Funds (ESIF) involving various national and regional governments in Europe. Within the initiative, risk should be allocated not only through mezzanine guarantees but also via investment in senior tranches and the non-retained part of junior tranches.

achieved by an IRB originator in a tranching cover transaction can be material (almost 60% capital relief).

4. The fundamentals of synthetic securitisation

56. The market of synthetic securitisation, to a much larger extent than the one of true sale securitisation, has traditionally been characterised by issuance of bespoke and bilateral transactions, i.e. a non-standardised market. In particular, the credit protection mechanism, which is the core of a synthetic securitisation transaction and constitutes the structural element of difference with respect to true sale transactions, has been implemented in accordance with a wide spectrum of practices. This section reviews the fundamental building blocks of a credit protection mechanism used in synthetic securitisation, and the market practices that can be observed according to evidence collected by the EBA.

57. It should be kept in mind that, within a credit protection agreement, similar to an insurance contract, different contractual practices strike a different balance in the conflict of interest between the protection buyer and the protection seller. From a regulatory/supervisory perspective, the risks incurred by both the protection seller (i.e. the investor's perspective) and the protection buyer (originator's perspective) should be adequately addressed.

58. The following structural aspects of a synthetic securitisation transaction are reviewed in this section.

- a) The definition of credit events;
- b) The timing and determination of credit protection payments;
- c) The moral hazard /conflict of interest arising in the calculation of the credit protection payments;
- d) The use of synthetic excess spread;
- e) Termination events;
- f) Counterparty credit risk.

4.1 Definition of credit events

59. Credit events are those events that trigger credit protection payments from the protection seller to the protection buyer within a credit protection contract. The relative 'conservative' nature of the definitions chosen for these events determines the likelihood of them occurring

and, consequently, determines the different levels of loss for investors and the different levels of protection for originators.

60. Broadly speaking, other things being equal, a less conservative credit event definition (an event more likely to occur) is a favourable condition from the protection buyer's perspective, while a more conservative credit event definition (an event less likely to occur) is a favorable condition from the protection seller's perspective, as protection is less likely to trigger. Depending on how credit protection payments are determined and scheduled (see the next section), a less conservative credit event can imply an increased need for adjustment payments, i.e. late payments carried out at the end of the loss work-out period in cases where the initial payments made at the time of the credit event do not correctly reflect the fully worked out losses. Potentially, this implies an increased extent of counterparty credit risk.

61. Typical credit events include:

- a) Failure to pay after 90 days (i.e. 90 days past-due);
- b) Restructuring of the reference credit/obligor;
- c) Bankruptcy of the reference credit/obligor.

62. Box 3 in the annex to this report provides the definitions of credit events for a sample guarantee contract.

4.2 Timing and determination of credit protection payments

63. The allocation of losses between investors and originators also depends on the type of arrangement that the parties choose in order to quantify and schedule credit protection payments. Credit protection payments can be executed, inter alia:

- a) Immediately after a credit event for the full amount of defaulted assets;
- b) Immediately after a credit event for the full amount of defaulted assets net of expected recoveries;
- c) After a pre-determined period allowed for collection activities, i.e. a 'work-out' period, for a sum equal to the actual loss incurred over that pre-determined period;
- d) After a predetermined period allowed for collection activities, for a sum equal to the actual loss minus the expected recoveries;
- e) After full workout of losses, for the actual losses.

64. Whereas the allocation mechanism (e) ensures that losses covered by the protection seller are fully aligned with those that the protection buyer ultimately incurs, allocation mechanism (a) may result in systematic overestimation of losses in favour of the protection buyer.

65. In addition, loss allocation is influenced by:

- i) Payment components that are often defined as ‘ancillary payments’ within credit protection payments, arising from a wide range of circumstances including missed interest payments, interest penalties and foreclosure costs;
- ii) As mentioned above, payment components defined as ‘adjustment payments’, which tend to be executed after the maturity of the credit protection agreement in order to compensate mistakes in previously estimated and exchanged amounts.

66. Foreclosure costs and other costs of the recovery process are typically deducted from recovery amounts.

67. According to the informal discussions that the EBA held with market participants, contracts normally combine:

- i. An ‘initial loss settlement’ following the occurrence of the credit event, based on either a predetermined expected loss figure or the loss given default estimate of the originator (e.g. the originator is an IRB bank and can typically document the basis of the estimate using a sufficiently long, loss performance history).
- ii. A subsequent work-out period, at the end of which the originator and the investor make adjustment payments to align the initial settlement with the fully worked out loss amounts. Work-out periods can be of 1 or, 2 year or longer, whereby a work-out period of up to 5 years should encompass the practice of most past and actual transactions in the market. It should be noted that, in certain jurisdictions, the work out period cannot be contractually determined, as it is established by the national insolvency regime.

68. Market participants take the following views:

- a) Investors appear to be keen to ensure that the losses they are ultimately asked to cover correspond to the losses that the originator records in its profit and loss account at the time of settlement. Certain standard guarantee contracts include a clause capping the credit protection payments at the loss amounts the protection buyer records in its profit and loss accounts. In cases where the work-out activities are excessively long, certain investors choose to accept final settlements that are aligned to the loss amounts recorded in the originator’s profit and loss account at the time of the settlement and/or reach an agreement with the protection buyer on the final payments to be made;

- b) Originators may be keen on determining and realising protection payments only at the end of the work-out period, instead of using an initial loss settlement, due to the operational costs of carrying out calculation and payment procedures at each occurrence of a credit event.

69. Certain stakeholders also highlight that, particularly in the case of fully funded credit protection contracts where the funding is readily and safely available for the benefit of the protection buyer, the ultimate timing (schedule) mechanism of the credit protection payments should be left to contractual agreements, and should not be standardised. From a regulatory/supervisory perspective, the impact of the payments' determination and timing on the regulatory capital position of the protection buyer should be given consideration.

70. Throughout the process of determination and allocation of losses and payments the conflict of interest between the protection buyer and the protection seller, and the related potential for moral hazard behaviours, are major issues that should be given consideration. The next section covers the role of external verification agents in addressing and mitigating the risk of moral hazard.

4.3 Moral hazard in credit protection contracts

71. Conflicts of interest may arise within a synthetic transaction due to the process of calculating/estimating losses and expected recoveries that, in turn, determine credit protection payments from the protection seller to the protection buyer. This is particularly the case when and this appears to be market practice the protection buyer itself also acts as a calculation agent, hence exercising discretion in determining the amounts it is to receive from the protection seller.

72. In order to mitigate the moral hazard arising in such a setting, transaction documentation often provides for the existence of a **verification agent**, or a similar independent third party, whose tasks may include, but are not limited to, verifying the following conditions:

- a) That a credit event notice has been given, stating that the relevant credit event in terms of a reference obligation has occurred and the amount of outstanding indebtedness;
- b) The realised loss of a liquidated reference obligation at the end of the work-out period as calculated by the calculation agent, taking into account the recovery received (or defined) and the appropriate amount of expenses;
- c) The accuracy of the determination of estimated losses/recoveries;
- d) The correct determination of the work-out period for any liquidated reference obligation for which a realised loss has been notified;
- e) The contents of each portfolio report and investor report;

- f) That all eligibility and replenishment criteria were met for each reference obligation on the date the reference obligation was included in the reference portfolio and/or on the date when the default occurred;
- g) Occurrence and accuracy of adjustment payments, when needed;
- h) Servicing and work-out procedures in line with defined servicing standard.

73. The verification of the underlying exposures' eligibility criteria (point (f) above) may be more important in synthetic securitisation than in true sale securitisation. This is because, in those cases where potential ineligible exposures were identified late in the life of the transaction for instance, when a credit event had already occurred for these specific exposures credit protection on these exposures would promptly become invalid, leaving the exposures unprotected. While this would reduce the actual exposure of the protection seller, from a regulatory/supervisory perspective, it would leave the originator with a no longer fully justified SRT recognition.

74. In addition, the conflict of interest of the protection buyer also acting as the calculation agent can be addressed by requiring the originator to retain economic interest in each loan and/or imposing an **operational separation (a so-called Chinese wall)** within the structure of the originator, between the department working on credit and collection activities and the department structuring synthetic securitisation transactions. Similar arrangements should ensure that, in exercising credit and collection activities, the originator institution's staff is not aware of which exposures benefit from credit protection, as awareness of the latter may disincentivise careful and proper credit and collection activities, as well as fair and correct loss calculation activities.

75. Consistency of servicing across exposures subject to synthetic risk transfer and exposures whose credit risk is not transferred appears to be a fundamental principle from the investor's perspective according to informal evidence collected by the EBA.

4.4 Use of synthetic excess spread

76. Synthetic excess spread is the remaining income from the securitised assets after servicing, legal funding costs and all other relevant expenses have been deducted. Some synthetic transactions make use of synthetic excess spread ledger mechanisms, whereby the synthetic excess spread is used to provide some form of protection to investors, i.e. it absorbs losses on a first-loss basis. Excess spread is typically used, in accordance with one of the following mechanisms:

- a) **The 'use it or lose it' mechanism:** synthetic excess spread is usually available for a pre-determined period of time and in a pre-determined amount, e.g. a percentage of the non-written off notional. If losses occurring during that period are lower than or equal to the excess spread amount the latter covers the losses and no loss has to be covered by investors. If instead losses over the period are

higher than the excess spread, then investors incur write-offs for the amount of losses exceeding the available excess spread. Unconsumed excess spread is passed back to the originator;

- b) **The 'trapped' mechanism:** synthetic excess spread is usually available in a pre-determined amount, e.g. a percentage of the non-written off notional. Unused excess spread is normally trapped in the transaction, i.e. accumulated in a reserve account.

77. From a regulatory/supervisory perspective, the use of excess spread in synthetic transactions may raise concerns mostly related to the actual occurrence of significant risk transfer, which is a necessary condition for justifying regulatory capital relief. Certain ways of using synthetic excess spread may, in fact, offset the actual risk transferred to the credit protection seller (i.e. the investor) as a result of the transaction. In this regard, it should also be noted that specific regulatory packages -such as the EBA Guidelines on SRT (and the follow-up on those) and, at the global level, the BIS work under consultation on 'high cost credit protection'- are the appropriate instruments to address concerns on SRT and harmonise regulatory treatment in that space, independently from the qualifying securitisation reform.

78. According to evidence informally collected by the EBA, the use of synthetic excess spread for the protection of the investor is a rather common practice in the market, although many transactions were issued that do not give excess spread any role. Investors take into account whether or not excess spread ensures any protection when pricing the deals and where excess spread is not used for protection synthetic transactions tend to be structured with larger first loss tranches (potentially leading to higher regulatory capital costs for originators). Among the major three ECAIs, only one of them seems to give some credit to excess spread protection mechanisms when assigning external ratings to synthetic transactions.

4.5 Termination events

79. Within credit protection contracts the definition of events determining the termination of the contract itself is crucial in determining credit protection outcomes. A termination event is an event after which no losses can be claimed in relation to the occurrence of credit events.

80. Box 4 and Box 5 in the annex to this report provide the definitions of termination events for a sample guarantee contract.

81. From a prudential regulatory perspective, it is important to consider the interaction between originators' regulatory capital, significant risk transfer and credit protection termination events. When obtaining the regulator's approval for significant risk transfer, originators of synthetic securitisation transactions obtain capital relief i.e. they have to comply with lower capital requirements than those they would incur outside the securitisation framework. The risk transfer relies on the validity of the credit protection agreement: if the bankruptcy of the originating institution entitles the protection provider to unilaterally call for the termination of

the credit protection agreement the creditors of the originator cannot benefit from such protection and can only rely on the protection of the institution's own funds which, by contrast, has been reduced to take account of that protection.

82. It should be noted that the termination of credit protection at the insolvency/resolution of the protection buyer is a relevant issue not only for synthetic securitisation but also in the broader context of hedging and credit risk protection activities.

83. Based on preliminary discussions held with various stakeholders it appears that the inclusion of bankruptcy among early termination events is a widespread practice in the synthetic securitisation market. For this reason, the impact of excluding that event from standardised synthetic contracts should be carefully assessed. From an investor's perspective, at least the following two elements should be considered:

- a) Where the bankruptcy/resolution of the protection buyer was not a trigger of early termination, the investor's interests would be protected as long as the insolvency estate of the protection buyer ensures regular payment of the credit protection premium. A failure to pay such a premium would still configure as a recognised termination event;
- b) The investor's interest may be undermined in relation to the protection buyer's capacity to ensure adequate servicing standards during a phase of bankruptcy/resolution.

4.6 Counterparty credit risk

84. Different forms of counterparty credit risk can arise in credit protection contracts used for synthetic risk transfer.

85. The major form of counterparty credit risk characterises synthetic risk transfer via unfunded credit risk mitigation instruments. In unfunded transactions the protection buyer is fully exposed to the insolvency risk of protection seller, i.e. the risk that credit protection payments will not occur as they become due, due to the protection seller's default. The absence of funding is a feature of the credit protection contract that leaves the actual effectiveness of credit risk transfer fully dependent on the creditworthiness of the credit protection provider.

86. Full funding of credit protection, whereby the protection seller is required to fund ex ante the protection commitment on which it has agreed and whereby the funding is appropriately segregated away from the protection seller itself, addresses and mitigates the counterparty credit risk exposure of the protection buyer towards the protection seller, materially reducing the extent to which the effectiveness of credit risk transfer depends on the creditworthiness of the protection seller.

87. In addition, synthetic transactions can be characterised by the following forms of counterparty credit risk:

- a) Depending on where the cash or collateral used to fund the credit protection agreement is deposited/re-invested, the transaction may become exposed to the insolvency risk of the account bank and the custodian, and/or to the credit and market risk of the securities in which the cash is reinvested or that collateralise the protection;
- b) The credit protection seller (the investor) is exposed to the insolvency risk of the credit protection buyer in relation to the credit protection premium payments that the buyer owes to the seller;
- c) In funded credit protection arrangements, the credit protection seller is exposed to the insolvency risk of the credit protection buyer in relation to adjustment payments due to correct credit protection payments that have been initially made for amounts higher than the final determination (work-out) of actual incurred losses.

88. Different measures may be adopted to address the risks at point (a) above, including:

- Rating trigger conditions and replacement language for the account bank in which the cash of the funded agreement is credited. The excessive counterparty concentration risk that may arise from crediting the full amount of the cash with only one institution may be mitigated by using more than one account bank;
- Limits to the maturity and credit quality of the securities that can collateralise the protection agreement and/or in which the cash collateral can be re-invested. This may include agreements with repurchase agreement providers that commit to covering the market risk of the securities.

89. The risk at point (b) above is typically mitigated by arrangements of pre-funding of the premium payments.

90. The risk at point (d) above is structurally mitigated in those transactions where the determination and schedule of credit protection payments rely more substantially on the final (post work-out) settlement than on the initial loss settlement.

5. A differentiated regulatory treatment of synthetic securitisation in the current market/regulatory environment

5.1 The scope of regulatory differentiation

91. The EU proposal of a qualifying framework for traditional (i.e. true sale) securitisation has been developed in parallel with global discussions, and consultations with stakeholders', on reviving securitisation markets globally. Shortly after the EBA published its advice to the Commission in July 2015, which covered traditional term securitisation and ABCP securitisations, the BCBS and IOSCO Committees published criteria defining simple transparent and comparable (STC) securitisations (July 2015).¹⁰ Whereas the BCBS/IOSCO standards do not cover ABCP securitisations, the publication clarifies that the Committees will consider whether and how to take forward the work on short-term securitisation, including ABCPs.

92. The EBA advice has informed the Commission's publication of a proposal for a securitisation regulation with an accompanying amendment of the CRR provisions on securitisation. At the global level, the STC standards have informed the publication of a BCBS Consultation Paper (October 2015)¹¹ seeking stakeholders' views on the re-calibration of capital requirements for traditional term STC securitisation.

93. Synthetic securitisation was left outside the scope of the 'qualifying' (EBA) and 'STC' (BCBS) reforms i.e. it was assigned the regulatory capital treatment foreseen by the Basel 2014 revision of the securitisation framework. At this stage, therefore, no global standards exist to identify a subset of synthetic securitisation products as simple, standard/comparable and transparent products. Furthermore, global standard setters do not currently foresee engaging in any initiative aimed at reviving the market for synthetic securitisation.

94. The Commission, in its proposal amendment of the CRR that implements a differentiated regulatory treatment for STS securitisations, has introduced an element of differentiation in the treatment of synthetic transactions (see Article 270 of the proposal amendment of the CRR),¹² whereby the applicability of STS risk weights is extended to exposures arising from senior synthetic securitisation tranches retained by originator institutions within specific transactions. The eligible synthetic transactions fulfil the following requirements:

¹⁰ <http://www.bis.org/bcbs/publ/d332.pdf>.

¹¹ <https://www.bis.org/bcbs/publ/d343.pdf>.

¹² http://ec.europa.eu/finance/securities/docs/securitisation/com-2015-473_en.pdf

- a) At least 80% of the securitised exposures are exposures to SMEs, as defined in Article 501 of the CRR;
- b) The credit risk not retained by the originator has to be transferred through a guarantee, or counter guarantee, which complies with CRR requirements on credit risk mitigation and where the guarantor/counter-guarantor is either a central government or central bank of a member state, a multilateral development bank or an international organisation. The guarantor or counter-guarantor has to classify for a 0% risk-weight according to the CRR.

95. The evidence and the analysis carried out for the purposes of this report support the overarching approach taken by the Commission's proposal, whereby:

- a) The differentiation in regulatory treatment focuses on balance sheet synthetic transactions and excludes those synthetics that were structured prior to the crisis to implement yield arbitrage strategies;
- b) The proposed changes focus on the bank's regulatory capital treatment of synthetic positions held (retained) by originating banks and do not extend to establishing a 'qualifying' (or STS, in the language of the Commission's proposal) cross-sectoral framework for synthetic securitisations applicable to originating and investing entities alike;
- c) The differentiation in regulatory treatment focuses on synthetic securitisations of SME exposures;
- d) The differentiation in regulatory treatment focuses on the most senior tranche of any given synthetic securitisation.

96. In relation to the different aspects of the approach outlined in (a) to (d), the elements of rationale listed below should be considered.

Focus on balance sheet synthetic securitisations

97. Within the market of synthetic securitisation balance sheet synthetics i.e. transactions structured by institutions to transfer exposures originated in their banking book off their balance sheet, performed consistently better than arbitrage synthetics and were typically structured to be far less complex than the latter. In addition, while 'balance sheet' synthetics fulfil, as their primary objective, the genuine risk transfer objective acknowledged for securitisation in prudential regulation, arbitrage synthetic transactions are primarily structured to achieve yield arbitrage targets driven by investors and asset managers.

Focus on prudential treatment of positions retained by originators

98. The vast majority of investors operating in the market of synthetic securitisation are very sophisticated non-bank investors, belonging to the categories of hedge funds, asset managers,

insurance companies, pension funds and other national or supranational promotional/development banks. This investor base tends to establish close and long-lasting bilateral relationships with originating banks and, typically, carries out deep due-diligence analysis, benefiting from full transparency on relevant information and data that is exchanged with originators on a bilateral basis. Against this background, the objectives of a fully-fledged 'qualifying' framework to assist the securitisation investor base in the due-diligence analysis of securitisation investments and to remove the stigma of complexity and riskiness for investors attached to securitisation following the financial crisis are less applicable to this segment of the market.

99. Due to the diverse composition of the investor base of the synthetic securitisation market, and the minor role that credit institutions play as investors, the regulatory capital treatment of banks' investment positions is not reported by stakeholders to be a hurdle for the market to function. By contrast, as reported above in this report, the regulatory capital treatment applicable to originating banks on retained synthetic positions, in particular the level of the risk-weight floor applicable to senior tranches, appears to be one of the key factors determining the extent of credit risk transfer from banks to non-bank entities and, consequently, the supply of synthetic products available in the market.

100. In addition, as outlined in the report, synthetic securitisation realises risk transfer by means of a credit protection contract. While, to date, no industry-led initiative has taken place that aims at promoting standardisation of market practices (comparable, for instance, to the PCS initiative on traditional securitisation, which has usefully informed various aspects of the qualifying framework for traditional securitisations), it seems clear that different contractual features can potentially result in very different degrees of protection for, the protection buyer (i.e. originator bank) and the protection seller (i.e. the investor). In particular, in a context where both the originator and the investor in a synthetic transaction are credit institutions, different contractual features can significantly bias the credit protection arrangement in favour of a prudentially stronger, significant risk transfer process for the originator and to the disadvantage of the investor, or vice versa. Designing a framework that provides preferential capital treatment only to originator institutions (protection buyers) facilitates striking the right balance between the standardisation of transactions and prudential regulatory/supervisory objectives.

Focus on 'SME' exposures

101. Maintaining an appropriate level of consistency between the criteria determining eligibility for qualifying regulatory treatment of traditional securitisation and the criteria determining eligibility for qualifying regulatory treatment of synthetic securitisation should in principle justify extending that treatment to the same set of asset classes irrespective of the type of securitisation technique. However, given the limited amount of available data on the performance of synthetic transactions, and taking into account that synthetic securitisation has typically been particularly active in the corporate/SME class (as this class is often less

suitable to a traditional securitisation format), it appears sensible, at this stage to limit the scope of the regulatory proposal to SME exposures.

Focus on senior tranches

102. Whereas the scope for a comprehensive comparison between the historical performances of traditional and synthetic securitisation tranches is limited (in particular within a given asset class and jurisdiction due to the current limited availability of data), available S&P performance statistics consistently show zero default levels for highly rated tranches (i.e. AAA and AA-rated tranches) in the SME CLO and other CLO asset classes. Among the most highly rated tranches, senior tranches should be those performing best due to their seniority. In addition to be above, systematic data on synthetic transaction structures, which would allow an assessment of the standard features of mezzanine securitisation tranches is not available at this stage. For these reasons, it appears prudent to limit the scope of regulatory differentiation to senior tranches.

103. In terms of the impact of the regulatory proposal on the functioning of the market, as mentioned above the level of the risk-weight floor applicable to senior tranches appears, in particular, to be one of the key factors determining the extent of credit risk transfer from banks to non-bank entities and, consequently, the supply of synthetic products available in the market.

5.2 Proposed amendments to the Commission's proposal Article 270

104. Although supporting the overall approach followed in Article 270 of the Commission's proposal, the analysis carried out and the evidence collected for the purposes of this report highlight that certain aspects of the mentioned proposal could be reconsidered. The approach could be reconsidered with respect to, in particular:

- a) Introducing the eligibility of fully cash-funded credit protection provided by private investors (amending Article 270(d) and 270(e));
- b) Amending the criteria determining eligibility for qualifying regulatory capital treatment (amending Article 270(a)).

105. These points are treated in the following sections.

Fully cash-funded credit protection provided by private investors

106. As assessed in this report, synthetic securitisation typically transfers risk either through unfunded credit protection arrangements (e.g. financial guarantees) or through fully funded credit protection arrangements. In the post-crisis market environment, due to the scarcity of highly rated private investors, fully funded credit protection has come to prevail over unfunded credit protection. In particular, originator institutions purchase unfunded credit

protection almost exclusively from 0% risk-weighted counterparties, such as central governments and multilateral development banks, whereas they require full funding for the credit protection from private market investors, such as insurance companies, asset managers and hedge funds.

107. Available data by BofAML shows that all synthetic securitisation tranches recorded for 2013 and 2014 represent funded securitisation transactions. The voluntary data collection exercise carried out by the EBA highlights that only approximately 2% of the investor base of synthetic securitisation transactions issued on a bilateral basis by twelve large European issuers during years 2008-2014 comprises central governments and 0% risk-weighted multilateral development banks and, as such, would be eligible under Article 270 of the Commission's proposal. The vast majority of the investor base is represented by, in order of importance, hedge funds, pension funds, asset managers, and other entities, the vast majority of which fund the credit protection they provide to originator institutions.
108. As described in the report, funded credit protection can be structured according to various market practices, which protect to a different extent the originator institution. In particular, full cash funding of credit protection by the protection seller where the cash collateral is deposited directly with the originator institution (protection buyer) realises the highest extent of protection for the originator, as it allows the originator to gain access to credit protection in a very timely fashion and without incurring any market/credit risk losses.
109. While this practice of funding is typically less desirable from the investor's perspective, as the investor has to face the protection buyer's counterparty credit risk on the cash it provides and cannot secure for itself return on collateral in the form of securities, full cash funding deposited with the originator realises (for the latter) an outcome of zero counterparty credit risk that is equivalent, in prudential terms, to the 0% risk weighting of special (public) counterparties.
110. In addition, it should be noted that while unfunded credit protection provided by 0% risk-weighted counterparties exposes the transactions to these counterparties' risk of downgrade (with effects such as related potential counterparty replacement triggers, increases in the capital costs of the transaction and potential outcomes of non-compliance with the proposed regulatory framework), fully funded credit protection in the form of cash does not present such undesirable implications.

Overarching consistency between the criteria determining the 'qualifying' capital treatment of synthetic securitisations and the 'qualifying' capital treatment of traditional securitisations

111. The criteria determining the eligibility of certain synthetic securitisation positions for 'qualifying' regulatory treatment should maintain a high degree of consistency with the criteria proposed in July 2015 to determine eligibility of traditional securitisations for 'qualifying' regulatory treatment.

112. This consistency appears necessary in light of the fact that a preferential capital treatment, as calibrated for traditional ‘qualifying’ securitisations (see Chapter 6 of the EBA report on qualifying securitisation – July 2015), can only be granted to retained synthetic securitisations if these securitisations achieve an overall level of quality that is comparable to the level required within the qualifying framework for traditional securitisations.
113. In particular, appropriate consistency among the respective criteria should ensure that:
- a) The overall complexity and riskiness of the securitisation structure is appropriately mitigated, so as to reduce the modelling (tranching) risk, operational risk, agency risk and legal risk incurred by the originator bank on the synthetic securitisation positions it retains. Mitigating these risks is as important for the originator’s positions as it is for the investor’s positions. In addition, consistency should ensure that the credit quality of the underlying exposures remains comparable;
 - b) The introduction of a differentiated prudential framework for certain synthetics does not change the incentives of a credit institution when it comes to adopting a given securitisation technique. Whereas the proposed framework for originator institutions should ensure consistency between the traditional and the synthetic techniques of securitisation, from an originator’s perspective, it should not result in the possibility of credit institutions securitising in a synthetic format exposures that, due to specific features of riskiness, are not eligible for securitisation under the ‘qualifying’ traditional framework.
114. Importantly, the overarching consistency targeted in this context should take due account of:
- a) Market participants’ feedback about those aspects of the qualifying framework for traditional securitisations that are not workable in synthetic securitisation transactions, due to fundamental specificities of the synthetic securitisation technique. For this reason, several criteria inherited from the qualifying traditional securitisation framework should be adjusted, or eliminated, as appropriate;
 - b) The focus of the proposal for synthetic securitisations on the originator’s positions. In this regard, those criteria of the qualifying framework for traditional securitisations that exclusively reflect an objective of investor protection should be disregarded. This includes, but is not limited to, the criteria imposing enhanced transparency standards with regards to investors. A differentiated regulatory treatment of the investor’s positions, which can only be justified if accompanied by enhanced standards of transparency with regards to investors, is not the object of this proposal.

115. Besides amending, as appropriate, the criteria of the qualifying framework for traditional securitisation, this proposal introduces synthetic securitisation-specific criteria aimed at:

- Ensuring that the differentiated regulatory treatment only targets balance sheet synthetic transactions, as opposed to synthetic transactions structured with the primary objective of arbitraging, due to the different yields involved [*see additional criterion 1 – balance sheet transactions*];
- Ensuring that the originator institution can rely on credit protection in an immediate and smooth fashion without facing either the counterparty credit risk of the protection provider or any market, credit or counterparty credit risk on the funding arrangement, in the case of funded credit protection [*see additional criterion 2 – eligible credit protection contracts and counterparties*];
- Ensuring that the credit protection contract is structured to adequately protect the position of the originator (protection buyer in the contract) from a prudential perspective [*see additional criterion 3 to additional criterion 7*].

5.3 EBA recommendations

RECOMMENDATION 1: Recommendation regarding the eligibility of fully cash-funded credit protection provided by private investors

Proposal Article 270 can be considered to be modified to extend qualifying regulatory capital treatment to senior retained tranches of those synthetic securitisation transactions where the credit risk of the non-retained positions has been transferred to private investors, irrespective of their credit quality and provided that these investors fund the protection in the form of cash and deposit the cash with the originator institution (see additional criterion 2 in Chapter 6 of this report).

Rationale

Full cash funding of the credit protection by the protection seller, whereby the cash collateral is deposited directly with the originator institution realises the highest extent of protection of the originator, as it allows the originator to gain access to credit protection in a very timely fashion and without incurring any market/credit risk losses.

For the originator, this form of credit protection realises an outcome of zero counterparty credit risk, which is equivalent, in prudential terms, to the 0% risk weighting of public/supranational counterparties.

In addition, unlike unfunded credit protection, cash-funded credit protection does not expose the transaction to the protection provider's risk of downgrade, potentially triggering replacement procedures and/or increased capital costs or a non-compliance status for the transaction.

It should be considered that based on evidence collected by the EBA, only a very minor share of the investor base of the synthetic securitisation market in the period 2008-2014 fulfils the specific counterparty requirements currently provided for in the proposal Article 270.

RECOMMENDATION 2: Recommendation regarding the criteria determining eligibility to the qualifying regulatory capital treatment

Proposal Article 270 can be considered to be modified to include within the CRR, as eligibility requirements for qualifying regulatory treatment of certain synthetic securitisation positions, the criteria proposed in Chapter 6 of this report. These criteria should replace the current reference to the Securitisation Regulation proposal and the STS criteria for traditional securitisation transactions therein and only apply in the context of Article 270.

Rationale

Whereas an overall level of consistency should be kept between the criteria determining eligibility for qualifying regulatory treatment of traditional and of synthetic securitisation positions, so as to ensure an overall comparable quality of the two products, reference to the fully fledged STS framework for traditional securitisations, as included in the Securitisation Regulation is not appropriate to define eligibility for synthetic securitisation, for the following reasons:

- 1) Several STS criteria need to be amended, as they are not workable in the case of synthetic securitisation;
- 2) The proposal included in Article 270 of the Commission's CRR amendment focuses on the positions of the originator institution, while the STS framework for traditional securitisations was designed to fully protect securitisation investors on a cross-sectoral basis;
- 3) The specificities of the synthetic risk transfer mechanism require the introduction of additional criteria aimed at ensuring that the credit protection contract is structured in a standardised fashion to adequately protect the position of the originator.

In this regard, see also the elements of rationale in Section 5.2 of this report, as well as the rationale of each proposed criteria in Chapter 6.

6. Criteria for a ‘qualifying’ treatment of synthetic securitisation

Criterion 1:

The securitisation should meet the following conditions:

- It should be a synthetic securitisation as defined in the CRR (as per Article 242(11));
- It should not be a re-securitisation as defined in the CRR (as per Article 4(1) point (63)).

Rationale

The proposed regulatory differentiation targets the prudential treatment of senior synthetic securitisation positions retained by the originator institution in transactions over which the originator has achieved significant risk transfer. Compliance with the CRR’s definition of synthetic securitisation is a pre-condition for SRT achievement in accordance with Article 244 of the CRR.

In the past, re-securitisations have been structured into highly leveraged structures where lower credit quality notes could be re-packaged and credit enhanced, resulting in transactions where small changes in the credit performance of the underlying assets severely impacted the credit quality of the re-securitisation tranches. The modelling of the credit risk arising in these bonds proved very difficult, due to high correlations arising in the resulting structures. Unlike balance sheet synthetics, synthetic re-securitisations were often structured with arbitrage purposes, and did not serve with credit risk transfer as a primary objective. In addition, unlike balance sheet synthetics, synthetic re-securitisations performed materially worse than qualifying traditional securitisation. For these reasons, synthetic re-securitisations are excluded from the scope of the proposed regulatory differentiation.

Criterion 2:

The securitised exposures should at all times be subject to predetermined and clearly defined criteria determining their eligibility for protection under the credit protection agreement. Exposures added to the securitisation after the closing should meet eligibility criteria that are no less strict than those applied when structuring the securitisation. After the closing date the securitisation should not be characterised by an active portfolio management on a discretionary basis including the sale of exposures being protected under the credit protection agreement. Substitution of exposures that are in breach of eligibility criteria or replenishment criteria should in principle not be considered as active portfolio management.

Rationale

Eligibility criteria are essential safeguards in synthetic securitisation transactions as they determine the validity of the credit protection purchased by the originator institution. Originator institutions and protection providers should be in a position to identify in a clear and consistent fashion under which criteria exposures are selected to be securitised. The selection should not be an opaque process. Legal clarity over the eligibility for credit protection reduces legal risk and hence contributes to justifying the ‘qualifying’ prudential treatment being proposed for the originator’s retained senior position.

Active portfolio management adds a layer of complexity and increases the likelihood of cherry

picking practices occurring, which may undermine the effectiveness of credit protection and hence, increase the risk of the securitisation positions retained by the originator institution. Active management is deemed to arise whenever the manager of the portfolio sells one or more exposures that were initially included in the securitisation. Replenishment practices and practices of substitution for non-compliant exposures in the transaction should not be considered active management of the transaction provided that they do not result in any form of cherry-picking.

Replenishment periods and other structural mechanisms resulting in the inclusion of exposures into the securitisation after the closing of the transaction may introduce the risk that exposures of lesser quality could be added to the pool of exposures protected under the credit protection agreement. For this reason, it appears important to ensure that any exposure added to the securitisation after the closing meets eligibility criteria that are similar to, and not weaker than, those used to structure the initial pool of the securitisation.

Criterion 3:

The pool of securitised exposures should be homogeneous in terms of asset type, currency and legal system to which the securitised exposures are subject.

In addition, the exposures should meet the following criteria:

- i) They arise from obligations with contractually defined periodic payment streams relating to rental, principal, interest or principal and interest payments, or are rights to receive income from assets specified to support such payments.**
- ii) They are originated in the ordinary course of the originator's/original lender's business pursuant to underwriting standards that are no less stringent than those the originator/original lender applies to the origination of similar exposures not securitised.**
- iii) They contain a legal, valid and binding obligation of the obligor, enforceable in accordance with its terms, to pay the sums of money specified in it (other than an obligation to pay interest on overdue amounts).**
- iv) They are underwritten: (a) with full recourse to an obligor who is an individual or a corporate and who is not a special purpose entity, and (b) on the basis that their performance was not intended to be substantially reliant on the refinancing of the underlying exposures or re-sale value of the assets that are being financed by those underlying exposures.**

Rationale

See overarching rationale for consistency with traditional qualifying framework.

Criterion 4:

At the time of inclusion in the securitisation, the underlying exposures should not include:

- i) Any exposures with outstanding disputes between original lender and borrower regarding the underlying assets to the best of the originator's, sponsor's or original lender's knowledge;**
- ii) Any exposures that are non-performing. An exposure is considered to be non-performing if either or both of the following conditions are satisfied:**
 - a. it is more than 90 days past-due;**
 - b. the debtor is assessed as unlikely to pay its credit obligations in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due.**
- iii) Any exposures to a credit-impaired obligor. For these purposes, a borrower should be deemed as credit-impaired when, to the best of the originator's, sponsor's or original lender's knowledge:**

- a. the obligor has been the subject of an insolvency or debt restructuring process due to financial difficulties within the three years prior to the date of origination; or
 - b. the obligor is, to the knowledge of the institution at the time of inclusion of the exposure in the securitisation, recorded on a public credit registry of persons with adverse credit history, or other credit registry when a public one is not available in the jurisdiction; or
 - c. the obligor has a credit assessment by an ECAI or a credit score indicating significant risk of default.
- iv) Any transferable securities, as defined in Directive 2004/39/EC (MiFID) or derivatives, except derivatives used to hedge currency and interest rate risk arising in the securitisation.

Rationale

See overarching rationale for consistency with traditional qualifying framework.

Excluding transferable securities is particularly important in the case of synthetic transactions as it ensures that the proposed prudential treatment only targets ‘balance sheet’ transactions, as opposed to ‘arbitrage’ transactions that were structured in the past to include different types of securities as underlying exposures. Additional Criterion 1 ensures that only transactions backed by exposures for which the protection buyer is an originator (as defined under Article 4(1)(13) of the CRR) are eligible for the proposed framework.

For the sake of clarity, it should be highlighted that any derivative contract used to effect the credit risk transfer that gives rise to the securitisation is not to be considered an ‘underlying’ exposure of the synthetic securitisation.

Criterion 5:

At the time of inclusion, the underlying exposures are such that at least one payment has been made by the borrower, except in the case of revolving securitisations, where the underlying exposures are personal overdraft facilities, credit card receivables, trade receivables, trade finance obligations and dealer floorplan finance loans.

Rationale

See overarching rationale for consistency with traditional qualifying framework.

Criterion 6:

The securitisation should provide for the retention of a net economic interest in accordance with the CRR retention rules (Article 405 of the CRR) or any non-EU rules assessed as equivalent.

Rationale

See overarching rationale for consistency with traditional qualifying framework.

Criterion 7:

The guarantee and, where applicable, the collateral should be denominated in the currency in which the securitised exposures (i.e. the reference exposures) are denominated. The protection buyer should bear no currency risk in relation to the credit protection it receives.

Rationale

Unlike in the case of traditional (true sale) securitisation, in synthetic securitisation the interest and principal cash flows generated by underlying assets are not used to repay investors. Payments towards synthetic securitisation investors are limited to the credit risk protection

premium and, as applicable, the yield from the re-investment of the collateral funding, the transactions, and the redemption of such collateral of the notes at maturity or at early termination of the contract.

However the originator (protection buyer) of synthetic transactions may:

- Face instances of under-protection due to exchange rate fluctuations in transactions where more than one currency is involved;
- Be exposed to interest rate mismatches, itself or through the SSPE set up to issue notes to investors, where it guarantees to investors a return on the collateral received as credit risk protection beyond the payment of the due credit protection premium.

In synthetic securitisation transactions where the securitised exposures are denominated in a different currency than the currency in which the credit protection is denominated (i.e. the transaction currency) the risk arises that, due to exchange rate fluctuations and depending on the reference FX rate used for converting loss amounts into protection payment amounts, the outstanding amount of notes / available collateral / committed guarantee amount may result in under protection in respect of the reference exposures. This requirement, in conjunction with the requirement for each pool of securitised exposures to be denominated in a unique currency (see criterion 3) should eliminate currency risk borne by the originator (protection buyer).

Even though the CRR provides for additional capital requirements on the originator for transactions characterised by currency mismatches, it appears important that securitisation positions that are granted qualifying regulatory capital treatment are not exposed to any currency risk.

Additional criterion 2 provides for eligible funded credit risk protection arrangements to take the form of cash on deposit with the protection buyer. The absence of more complex collateral and re-investment arrangements should minimise the extent of interest rate mismatches.

Criterion 8:

The allocation of losses to holders of a securitisation position in a synthetic securitisation should always proceed in order of seniority, from the most junior position to the most senior position in the transaction.

Sequential amortisation should apply to all tranches. As the securitised exposures amortise, such amortisation should be applied first to reduce the most senior tranches and only once these most senior tranches have fully amortised to reduce more junior tranches in accordance with the order of seniority as agreed in the transaction documentation. As tranches amortise, where investors have provided collateral for those tranches, collateral should be returned to investors accordingly. In case of an exposure in relation to which a credit event has occurred and for which the workout process has not been completed, the sequential amortisation should leave tranches outstanding for a value that is at least equivalent to the notional outstanding amount of that exposure, net of the amount of any interim payment already effected on that exposure in relation to that credit event.

All applicable amortisation agreements should be clearly documented.

<p><u>Rationale</u></p> <p>See overarching rationale for consistency with traditional qualifying framework.</p> <p>The focus of the regulatory treatment of synthetics is on the prudential treatment of positions retained by the originator. Pro rata amortisation could potentially expose senior tranches to back loaded losses at a stage where there is little protection left for senior tranche due to amortisation from mezzanine and junior tranches.</p>
<p>Criterion 9:</p> <p>The transaction documentation should clearly specify the contractual obligations, duties and responsibilities of, as applicable, the trustee, verification agent, servicer and other ancillary service providers, as well as the processes and responsibilities necessary to ensure that:</p> <ul style="list-style-type: none"> i) the default or insolvency of the current servicer does not lead to a disruption to the servicing of the underlying assets, in cases where servicing is not provided by the originator itself; ii) upon default and specified events, the replacement of relevant counterparties, as applicable, is provided for in cases where the respective services for the benefit of the securitisation are not provided by the originator itself.
<p><u>Rationale</u></p> <p>See overarching rationale for consistency with traditional qualifying framework.</p>
<p>Criterion 10:</p> <p>The transaction documentation should clearly specify the duties of an ‘identified person’ with fiduciary responsibilities, who acts in the best interest of investors in the securitisation transaction to the extent permitted by applicable law and in accordance with the terms and conditions of the securitisation transaction, if relevant. The contractual transaction documentation should contain provisions facilitating the timely resolution of conflicts between different classes of holders of a securitisation position, including noteholders where applicable, by the ‘identified person’.</p>
<p><u>Rationale</u></p> <p>In order to ensure a well-functioning synthetic transaction and minimise the impact of potential conflicts, particularly where the risk of the securitised portfolio is transferred to more than one investor (e.g. where CLNs of different seniority are issued), the appointment of an identified person appears necessary.</p>
<p>Criterion 11:</p> <p>The underlying exposures shall be serviced in the same manner as other exposures of the originator, which belong to the same type of assets and are not securitised.</p> <p>The management of the originator or, where the originator does not act as servicer, the management of the servicer should demonstrate expertise in servicing the securitised exposures, supported by a management team with extensive industry experience. Policies, procedures and risk management controls should be well documented and there should be strong systems and reporting capabilities in place. The originator should have sufficient experience in originating exposures similar to those securitised.</p>
<p><u>Rationale</u></p> <p>Effective servicing standards are crucial in any synthetic securitisation, as the validity of the credit protection obtained heavily depends on the timely identification of relevant credit events protected under the credit protection agreement. Losses that are not identified at the time of their occurrence, due to servicing disruptions, may not be eligible for credit protection. Such risk increases the overall riskiness of the originator’s retained senior position. This appears to be</p>

particularly relevant in those cases where servicing is not carried out by the originator of the transaction.

Consistency and clarity of servicing standards, and sufficient experience with applying such standards, significantly reduce the extent of risks arising in relation to the servicing. In addition, qualifying synthetic securitisations should not be used to put in place any 'originate to distribute' behaviour through moral hazard practices arising in the servicing of exposures subject to protection.

See also overarching rationale for consistency with traditional qualifying framework.

Criterion 12:

A sample of underlying assets should be subject to external verification prior to issuance by an appropriate and independent party or parties, other than a credit rating agency, to verify (applying a confidence level of at least 99%) that the securitised exposures meet the criteria determining eligibility for credit protection.

Rationale

In synthetic securitisation compliance with contractual eligibility criteria determine the validity and therefore the effectiveness of the credit protection. From the perspective of the originator's prudential position it is crucial to ensure that any potential for disputes over the validity of the protection is minimised during the life of the transaction. For this reason, in the case of synthetic securitisation the audit prior to issuance should specifically cover eligibility conditions and should be carried out with a confidence level of at least 99%.

Criterion A:

Any underlying exposures should be originated in accordance with sound and prudent credit granting criteria as required under Article 79 of the CRDIV.

Such criteria should include at least an assessment of the borrower's creditworthiness in accordance with Articles 18, 19 and 20 of Directive 2014/17/EU (Mortgage Credit Directive) or Article 8 of Directive 2008/48/EC (Directive on credit agreements for consumers), to the extent that such standards would, according to their terms, in any case apply to the individual underlying exposures. Underlying exposures originated outside the EEA should be underwritten according to rules assessed as equivalent.

Rationale

See overarching rationale for consistency with traditional qualifying framework.

Criterion B: At inclusion the aggregated exposure value of all exposures to a single obligor in the pool do not exceed 1% of the exposure values of the aggregate outstanding exposure values of the pool of underlying exposures at that point in time. For the purposes of this calculation, loans or leases to a group of connected clients, as referred to in Article 4(1) point (39) of the CRR, should be considered as exposures to a single obligor.

Rationale

See overarching rationale for consistency with traditional qualifying framework

Criterion C: At the time of inclusion the securitised exposures should classify as exposures to SMEs, as defined in Article 501 of the CRR, and should fulfil each of the following conditions:

- i) They have to meet the conditions for being assigned, under the standardised approach and taking into account any eligible credit risk mitigation, a risk weight equal to or smaller than:
 - a. 40% on an exposure value-weighted average basis for the part of the portfolio

where the exposures are loans secured by residential mortgages or fully guaranteed residential loans, as referred to in paragraph 1(e) of Article 129 of the CRR;

- b. 50% on an individual exposure basis where the exposure is a loan secured by a commercial mortgage;**
 - c. 75% on an individual exposure basis where the exposure is a retail exposure;**
 - d. or, for any other exposures, 100% of an individual exposure basis.**
- ii) Under (a) and (b) above loans secured by lower ranking security rights on a given asset should only be included in the securitisation if all loans secured by prior ranking security rights on that asset are also included in the securitisation.**
 - iii) Under (a) no loan in the securitised portfolio should be characterised by a loan-to-value ratio higher than 100%, measured in accordance with paragraph 1(d)(i) of Article 129 and paragraph 1 of Article 229 of the CRR.**

Rationale

Maintaining an appropriate level of consistency between the criteria determining eligibility for qualifying regulatory treatment of traditional securitisation and of synthetic securitisation should in principle justify extending that treatment to the same set of asset classes irrespective of the type of securitisation technique. However, given the limited amount of available data on the performance of synthetic transactions and taking into account that synthetic securitisation has typically been particularly active in the corporate/SME class (as this class is often less suitable to a traditional securitisation format), it appears sensible, at this stage, to limit the scope of the regulatory proposal to SME exposures.

In accordance with Article 501 of the CRR exposures qualifying as exposures to SMEs shall be included in either the retail, corporates or secured by mortgages on immovable property classes. The maximum risk weight criteria provided for in this criterion, by exposure class, ensure that a minimum underlying credit quality is achieved within each part of the securitised SME exposures belonging to a particular exposure class.

Additional criterion 1 [*balance sheet transactions*]:

The protection buyer under the credit protection arrangements referred to in additional criterion 2 is an originator with respect to the securitised exposures as defined in Article 4(1) point (13) of the CRR. When the protection buyer is an originator with respect to the securitised exposures as defined in Article 4(1) point (13)(b) of the CRR, the originator shall apply to the purchased exposures credit and collection policies, workout policies and, where applicable, servicing policies that, are no less stringent than those the originator applies to similar exposures that were not purchased.

Where purchased from a third party, the securitised exposures should in any case be exposures originated, in accordance with Article 4(1) point (13)(b) of the CRR, by a credit institution, as defined in Article 4(1) point (1) of the CRR.

The securitised exposures, and the obligations of the reference obligors from which those exposures arise, should be identified at all times via a reference register. The reference register should clearly identify, at all times, the reference obligors, the reference obligations, the reference obligation notional amount outstanding, and the protected notional amount for each

reference obligation and obligor.
Rationale

The overarching objective of the proposed regulatory differentiation is to target balance sheet synthetic transactions, i.e. those transactions where the credit institution's primary objective is the transfer of credit risk of exposures that the institution itself holds on balancesheet. These transactions are also described in the Basel II framework as *tranche cover transactions*, in which the bank transfers a portion of the risk of a pool of balance sheet exposures in one or more tranches to a protection seller or sellers and retains some level of risk of the pool. In these transactions, the risk transferred and the risk retained are of different seniority.

The regulatory proposal should not cover transactions where the originator institution purchases exposures for the sole purpose of writing credit protection on them (i.e. securitising them) and arbitraging on the yields resulting from the transaction. Ensuring that the management of exposures purchased for the purposes of securitising them is consistent with that of similar exposures not securitised is important to avoid the occurrence of moral hazard behaviours by the originator institution that could result in an overall lesser credit quality of the securitisation transaction, ultimately affecting both retained positions and positions placed with investors.

The ultimate object of credit risk transfer should be exposures originated by credit institutions in their lending activity. Other instruments, commonly used in the arbitrage segment of the synthetic securitisation market, should be excluded.

The protection purchased should reference clearly identified reference obligations of clearly identified entities or obligors. The reference obligations on which protection is purchased should be clearly identified at all times via a reference register. If protection is purchased on the bank's entire exposure to an obligor, then the entire bank's outstanding – and future – loans should be entered in to the register. If a bank only purchases protection on some, but not all, of an entity's obligations, the subset of obligations on which protection is purchased must be registered in the registry.

Additional criterion 2 [eligible credit protection contracts and counterparties]:

The securitisation should achieve the transfer of risk by the use of:

- i. a guarantee meeting the requirements set out in Chapter 4 of Part Three Title II of the CRR, by which the credit risk is transferred to any of the entities listed under Article 214 (a) to (d) of the CRR, provided that the exposures to the protection provider qualify for a 0% risk weight under Chapter Two of Part Three Title II of the CRR, or;
- ii. a guarantee meeting the requirements set out in Chapter 4 of Part Three Title II of the CRR which benefits from a counter-guarantee of any of the entities referred to in point (i); or
- iii. unfunded credit protection meeting the requirements set out in Sub-Section 2 of Section 3, Chapter 4 of Part Three Title II of the CRR, provided that the obligations of the protection seller are fully cash-collateralised by cash on deposit with the protection buyer which meets the requirements set out in Sub-Section 1 of Section 3, Chapter 4 of Part Three Title II of the CRR.

Rationale

Unlike in the case of traditional (true sale) securitisation, in synthetic securitisation transactions the actual extent of credit risk transfer also depends on:

- The risk of default of the protection provider, in case of unfunded credit risk mitigation arrangements, or;
- The risk that the protection buyer may not have access to the collateral in a timely fashion and/or without incurring losses on the value of that collateral, in case of funded protection.

Extending to synthetic securitisation positions retained by the originator the prudential treatment granted to qualifying traditional securitisation positions can only be justified to the extent that synthetic transactions eliminate or adequately minimise the counterparty credit risk incurred by the originator institution, to adequately mimic comparable traditional securitisation positions where such risk does not arise.

In the case of unfunded credit risk protection arrangements, this is ensured by restricting the scope of eligible protection providers to those entities that are eligible providers in accordance with the CRR and that the CRR recognises as counterparties to be risk-weighted at 0% in accordance with the standardised approach for credit risk.

Where the counterparty is not recognised by the CRR to be eligible for a 0% risk weight, the resulting counterparty credit risk can be mitigated by requiring the counterparty to fully fund the credit protection by providing collateral. In particular, in order for the counterparty risk to be eliminated, the collateral that realises the protection should be held by the originator itself and has to take the form of cash. Other funding arrangements existing in the market practice pose the risk that the originator may not have access to the collateral in a timely fashion and/or without incurring losses on that collateral, ultimately weakening the extent to which the originator may rely on the protection and thereby, in effect, exposing the originator to counterparty credit risk.

As the proposed qualifying prudential treatment can only be applied by originators once the transaction achieves significant risk transfer, the existing CRR requirements on significant risk transfer (see Article 244(5)(d) of the CRR) already ensure that the originator has obtained an opinion from a qualified legal counsel confirming the enforceability of the credit protection in all relevant jurisdictions; thus, an additional criterion requiring that opinion is not needed to justify the 'qualifying' prudential treatment proposed in this report.

Additional criterion 3 [*eligible Credit events*]:

Credit protection agreements shall include at least the following three credit events:

- **Failure to pay, defined to encompass at a minimum the circumstances defined in Article 178 1(b) of the CRR;**
- **Bankruptcy, defined to encompass at a minimum the circumstances defined in Article 178 (3)(e) and (f) of the CRR;**
- **Restructuring, defined to encompass at a minimum the circumstances defined in Article 178(3) (d) of the CRR.**

The requirement to include at least these three events should not prevent the parties from agreeing additional and/or stricter credit events. Those credit events that are to apply, and their precise definitions, should be clearly documented.

Forbearance measures, as defined in Annex V Section 30 paragraphs 163 to 183 of Commission Implementing Regulation (EU) 2015/227 amending Implementing Regulation (EU) No 680/2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013, applied to securitised exposures shall not preclude the trigger of eligible credit events.

Rationale

In synthetic transactions that achieve SRT, credit protection (i.e. credit protection payments) justifies reducing the regulatory capital that the institution is required to hold against the risk of the securitised exposures. The definitions of credit events provided in the CRR shape the way prudential regulation quantifies the risk to be covered by regulatory capital. For the regulatory approach to quantifying risk to be adequately reflected in the credit protection agreement of synthetic securitisations it is important to ensure that the definitions of credit events included in the contract are, at a minimum, aligned with those provided for in the CRR.

The parties in the contract may agree on additional events or stricter definitions of the events mentioned in the criterion (e.g. failure to pay with a grace period of less than 90 days), in line with the general framework provided for in the standard industry master agreements, as long as that the credit protection agreement complies with the requirements provided for in Chapter 4 of the CRR and, at a minimum, the events taken into account for prudential purposes are included in the credit protection agreements.

Forbearance measures, which consist of concessions towards a debtor that is experiencing or about to experience difficulties in meeting its financial commitments, should not preclude the trigger of the protection event. In this regard, concessions refers to either a modification of the previous terms and conditions of a contract that the debtor is considered unable to comply with due to its financial difficulties ('troubled debt') resulting in insufficient debt service ability and that would not have been granted had the debtor not been experiencing financial difficulties; or a total or partial refinancing of a troubled debt contract, that would not have been granted had the debtor not been experiencing financial difficulties. A concession may entail a loss for the lender which should be considered within the credit protection agreement.

Additional criterion 4 [credit protection payments]:

The credit protection payment following the occurrence of a credit event should be calculated based on the actual realised loss suffered by the originator, as worked out in accordance with its standard recovery policies and procedures for the relevant type of exposures and as recorded by the originator in its financial statements at the time the payment is made.

Transactions should provide that an interim credit protection payment is to be made, at the latest, [1] year after the credit event has occurred in cases, where the workout of the losses for the relevant securitised exposure has not been finalised by that time.

The interim credit protection payment shall be, at least, the maximum of the considered impairment by the originator in the financial statements, in accordance with the applicable accounting framework, at the time the interim payment is made and, if applicable, the LGD determined in accordance with Part Three Title II Chapter 3 CRR that has to be applied to the corresponding securitised exposures in accordance with relevant capital requirements of the CRR. Where an interim credit protection payment is made, a final credit protection payment should be made in order to adjust the interim settlement of losses to the actual realised loss, in

accordance with the first paragraph of this criterion.

The method by which interim and final credit protection payments are calculated should be clearly specified in the credit protection contract.

Rationale

From the originator's perspective, in order to ensure that credit protection eventually covers the losses incurred by the originator and that the related SRT and capital relief decisions are justified, it is important that loss settlements do not fall short of the loss amounts as worked out by the originator. In addition, aligning credit protection payments to the loss amounts worked out by the originator ensures that the protection buyer's and the protection seller's interests in the transaction are more aligned, leading to better incentives on both sides of the transaction.

As the full work out of losses can be a lengthy process, depending on the type of asset class/collateral under consideration as well as the characteristics of national judicial and insolvency regimes, it is important from the perspective of the originator's capital position to ensure a minimum degree of timeliness in credit protection payments in all circumstances. For this reason, and also to ensure that the originator does not keep paying for credit protection on the protected notional amount of a given exposure when a credit event has occurred in relation to that exposure, an interim payment is required to take place. A final adjustment payment will have to be used to ensure the principle of adherence to the fully worked-out loss amounts.

The interim payment should reflect, at least, the originator's assigned LGD to the exposure (regulatory LGD or own estimate) for the purposes of determining its capital requirements. . Where the institution decides to recognise in its financial statements a higher figure than the mentioned LGD references, it is important that the interim payment reflects such a decision.

Additional criterion 5 [credit protection payments following the termination of the contract]:

With regard to securitised exposures for which a credit event has occurred and the workout process has not been completed 2 years after the scheduled maturity or early unwinding of a transaction (the final reference date), a final credit protection payment should be made on the basis of the losses/provisions for losses recorded by the originator in its financial statements at that time.

Rationale

As the full work out of losses can be a lengthy process, depending on the type of asset class/collateral under consideration as well as the characteristics of national judicial and insolvency regimes, It is important from the perspective of the originator's capital position to ensure a minimum degree of timeliness in credit protection payments. This not only increases certainty in the effectiveness of the credit protection arrangement from the perspective of the originator's prudential position, but also increases certainty from an investor's perspective, contributing to a well-functioning market.

Additional criterion 6 [verification agent]:

A third party 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 securitised exposure in relation to which a credit event notice was given:

- i. **that the credit event in the credit event notice occurred in accordance with terms of the**

<p>credit protection agreement;</p> <ul style="list-style-type: none"> ii. that the reference obligation met the portfolio eligibility criteria, at the time of inclusion in the reference portfolio, or the replenishment criteria at the time of replenishment, as applicable; iii. 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; iv. at the time the final protection payment is made, the allocation of losses to protection sellers in relation to that reference obligation.
<p><u>Rationale</u></p> <p>The appointment of a verification agent is a widespread market practice that enhances legal certainty in the transaction for all parties involved, thus decreasing the likelihood of disputes and litigations that could arise in relation to the loss allocation process. This result contributes to decreasing the overall riskiness of both retained positions and positions placed with investors and is instrumental to a-functioning transaction.</p>
<p>Additional criterion 7 [early termination by the originator]:</p> <p>Other than as a result of insolvency of the protection provider, failure to pay or breach of a material contractual obligation by the protection provider and an illegality arising in respect of the protection provider’s contractual obligations, the protection buyer shall only be permitted to terminate the transaction prior to its scheduled maturity when either of the following occurs:</p> <ul style="list-style-type: none"> i. relevant regulatory events (which should include regulatory capital, securities regulation, tax or accounting changes) [regulatory call]; ii. a time call is exercised, at a point in time, where the time period measured from the securitisation’s closing date is equal to or higher than the weighted average life of the initial reference portfolio at closing; [time call or economic call] iii. a call as per Article 245(4)(f) of the CRR is exercised; [clean-up call] <p>If any of these call rights are included in the transaction, they should be clearly specified in the documentation. Any other originator calls should not be allowed under the terms of the synthetic transaction.</p>
<p><u>Rationale</u></p> <p>Synthetic securitisation positions to which a ‘qualifying’ prudential treatment is granted should be part of transactions that do not feature complex <i>call</i> clauses for the originator. Whereas the merit of time calls is acknowledged from the originator’s perspective, in particular to ensure that the economic sustainability of the transactions is accounted for, originators should not use synthetic securitisation transactions with very short-dated time calls with the aim of temporarily changing the representation of their capital position on an ad-hoc basis.</p> <p>Suspensory conditions that make the validity of the protection agreement dependent on SRT approval by the competent authority in the comprehensive review after inception, should not be considered a regulatory call or an originator call as defined in this criterion.</p>
<p>Additional credit risk criterion A [qualifying treatment limited to senior (retained) securitisation positions]:</p> <p>The position retained by the originator qualifies as the most senior position within the securitisation transaction.</p>
<p><u>Rationale</u></p> <p>While the scope for a comprehensive comparison between the historical performances of traditional and synthetic securitisation tranches is limited, in particular within a given asset class</p>

and jurisdiction due to the current limited availability of data, available S&P performance statistics consistently show zero default levels for highly rated tranches (i.e. AAA and AA-rated tranches), for the SME CLO and other CLO asset classes. Among the most highly rated tranches, senior tranches should be those performing best due to their seniority. In addition, systematic data on synthetic transaction structures allowing for an assessment of the standard features of mezzanine securitisation tranches is not available at this stage. For these reasons, it appears prudent to limit the scope of regulatory differentiation to senior tranches.

7. EBA recommendations

RECOMMENDATION 1: Recommendation regarding the eligibility of fully cash-funded credit protection provided by private investors

Proposal Article 270 can be considered to be modified to extend qualifying regulatory capital treatment to senior retained tranches of those synthetic securitisation transactions where the credit risk of the non-retained positions has been transferred to private investors, irrespective of their credit quality and provided that these investors fund the protection in the form of cash and deposit the cash with the originator institution (see additional criterion 2 in Chapter 6 of this report).

Rationale

Full cash funding of the credit protection by the protection seller, whereby the cash collateral is deposited directly with the originator institution realises the highest extent of protection of the originator, as it allows the originator to gain access to credit protection in a very timely fashion and without incurring any market/credit risk losses.

For the originator, this form of credit protection realises an outcome of zero counterparty credit risk, which is equivalent, in prudential terms, to the 0% risk weighting of public/supranational counterparties.

In addition, unlike unfunded credit protection, cash-funded credit protection does not expose the transaction to the protection provider's risk of downgrade, potentially triggering replacement procedures and/or increased capital costs or a non-compliance status for the transaction.

It should be considered that based on evidence collected by the EBA only a very minor share of the investor base of the synthetic securitisation market in the period 2008-2014 fulfils the specific counterparty requirements currently provided for in the proposal Article 270.

RECOMMENDATION 2: Recommendation regarding the criteria determining eligibility to the qualifying regulatory capital treatment

Proposal Article 270 can be considered to be modified to include within the CRR, as eligibility requirements for qualifying regulatory treatment of certain synthetic securitisation positions, the criteria proposed in Chapter 6 of this report. These criteria should replace the current reference to the Securitisation Regulation proposal and the STS criteria for traditional securitisation transactions therein and only apply in the context of Article 270.

Rationale

Whereas an overall level of consistency should be kept between the criteria determining eligibility for qualifying regulatory treatment of traditional and of synthetic securitisation positions, so as to ensure an overall comparable quality of the two products, reference to the fully fledged STS

framework for traditional securitisations as included in the Securitisation Regulation is not appropriate to define eligibility for synthetic securitisation, for the following reasons:

- 1) Several STS criteria need to be amended as they are not workable in the case of synthetic securitisation;
- 2) The proposal included in Article 270 of the Commission's CRR amendment focuses on the positions of the originator institution, while the STS framework for traditional securitisations was designed to fully protect securitisation investors on a cross-sectoral basis;
- 3) The specificities of the synthetic risk transfer mechanism require the introduction of additional criteria aimed at ensuring that the credit protection contract is structured in a standardised fashion to adequately protect the position of the originator.

In this regard, see also the elements of rationale in Section 5.2 of this report as well as the rationale of each proposed criterion in Chapter 6.

8. Annex

Figure 9: Lifetime default rate true-sale vs synthetic RMBS tranches per rating grade (source: S&P as of 2014)

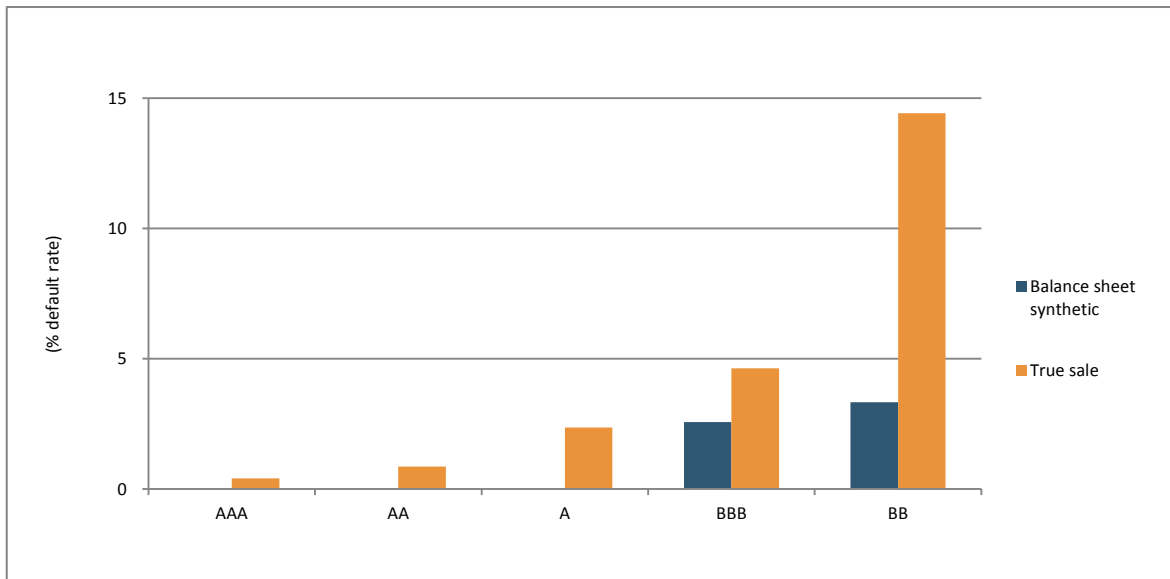


Figure 10: Lifetime default rate: true-sale vs synthetic SME CLO tranches per rating grade (source: S&P as of 2014)

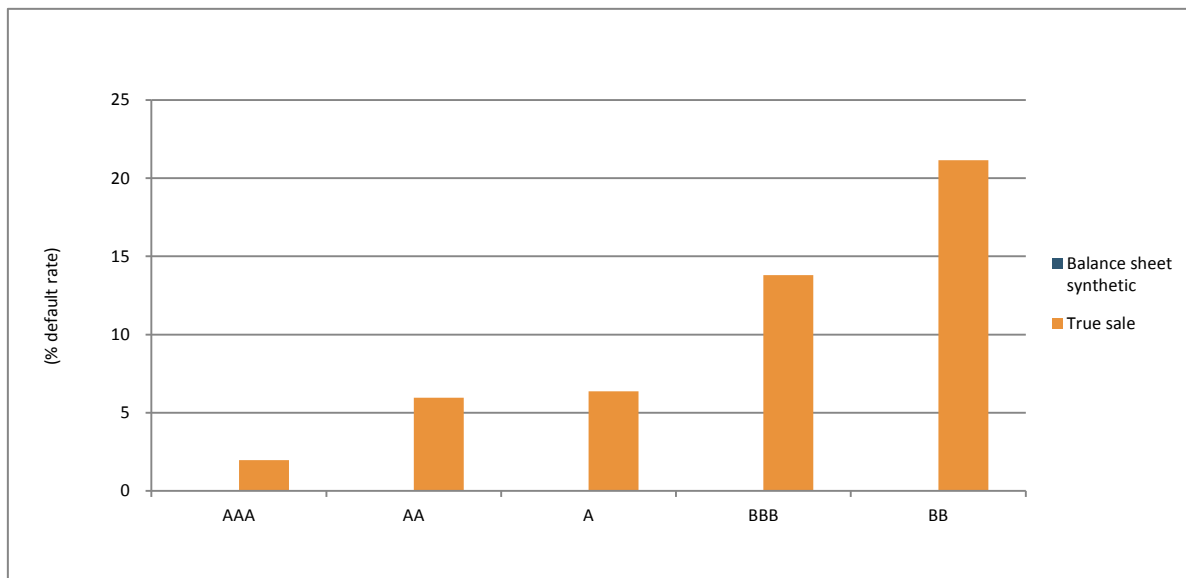


Figure 11: Lifetime default rate: true-sale vs synthetic CMBS tranches per rating grade (source: S&P as of 2014)

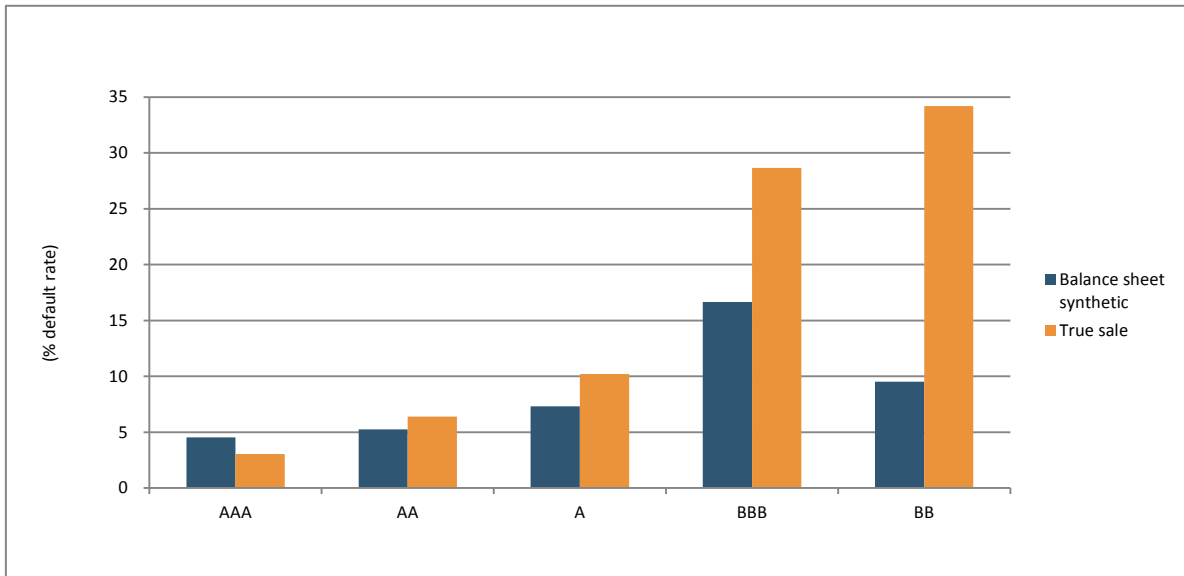


Figure 12: Lifetime default rate: true-sale vs synthetic Other CLOs tranches per rating grade (source: S&P as of 2014)

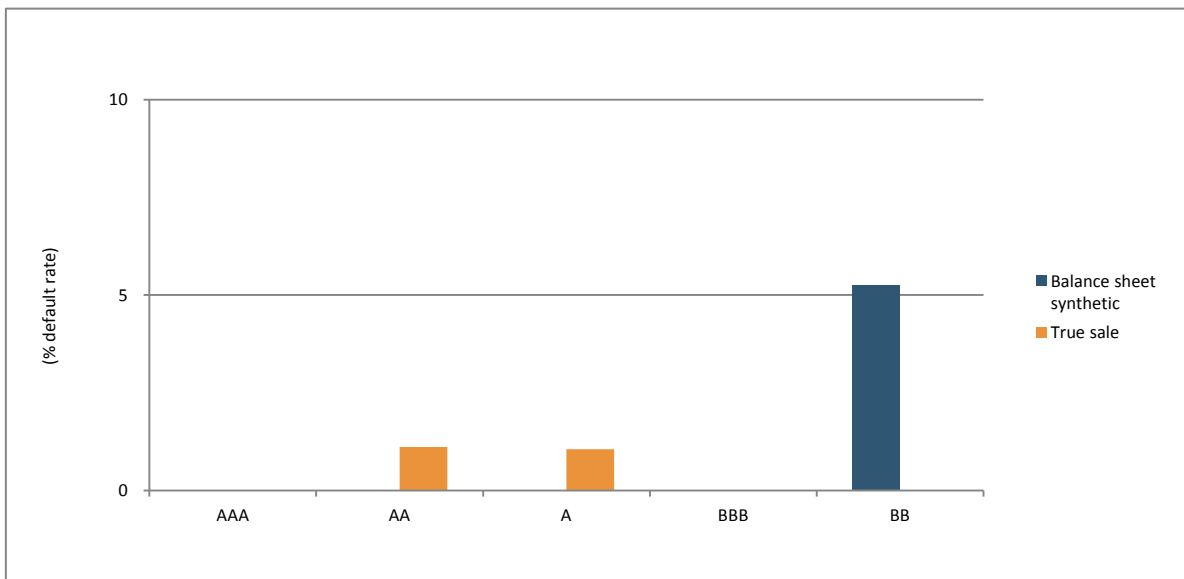


Figure 13: synthetic risk transfer: unfunded

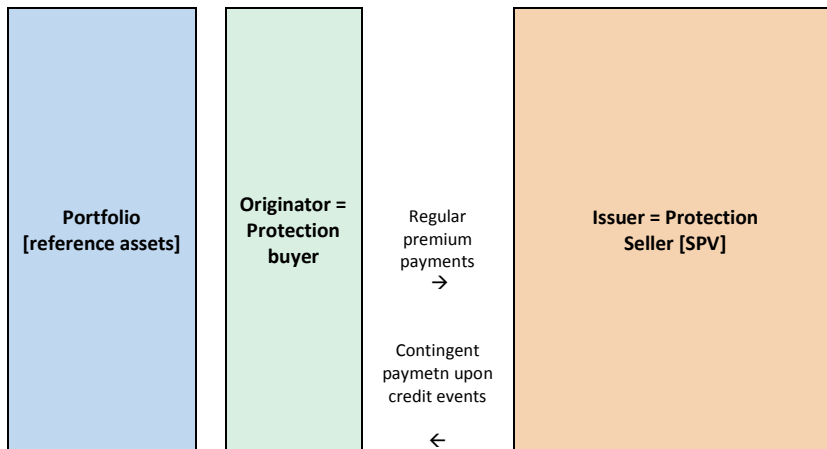


Figure 14: synthetic risk transfer: funded and unfunded credit risk protection within one transaction

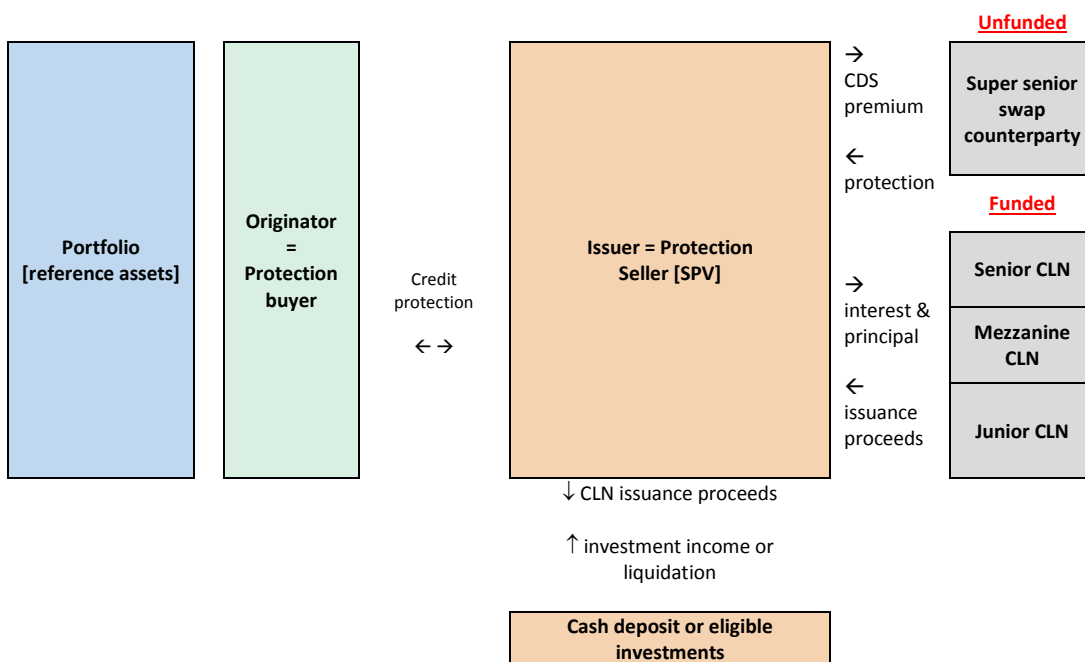


Figure 15: three-tranche tranching cover structure: unfunded and funded CRM combined

	seniority	Risk transferred to:		
Retained (5% vertical slice) (*)	Senior	retained		Originator
	Mezzanine	unfunded CRM (financial guarantee)		Supranational/Public
	Junior	20% retained	80% cash funded CRM	Originator/Private Investor

Figure 16: two-tranche tranching cover structure: CRM via cash collateral (funded)

	seniority	Risk transferred to:		
Retained (5% vertical slice) (*)	Senior	retained		Originator
	Junior	20% retained	80% cash funded guaranteed	Originator/Public Funds

Figure 17: Numerical example of capital relief within a tranching cover transaction. Mezzanine guarantee. IRB originator.

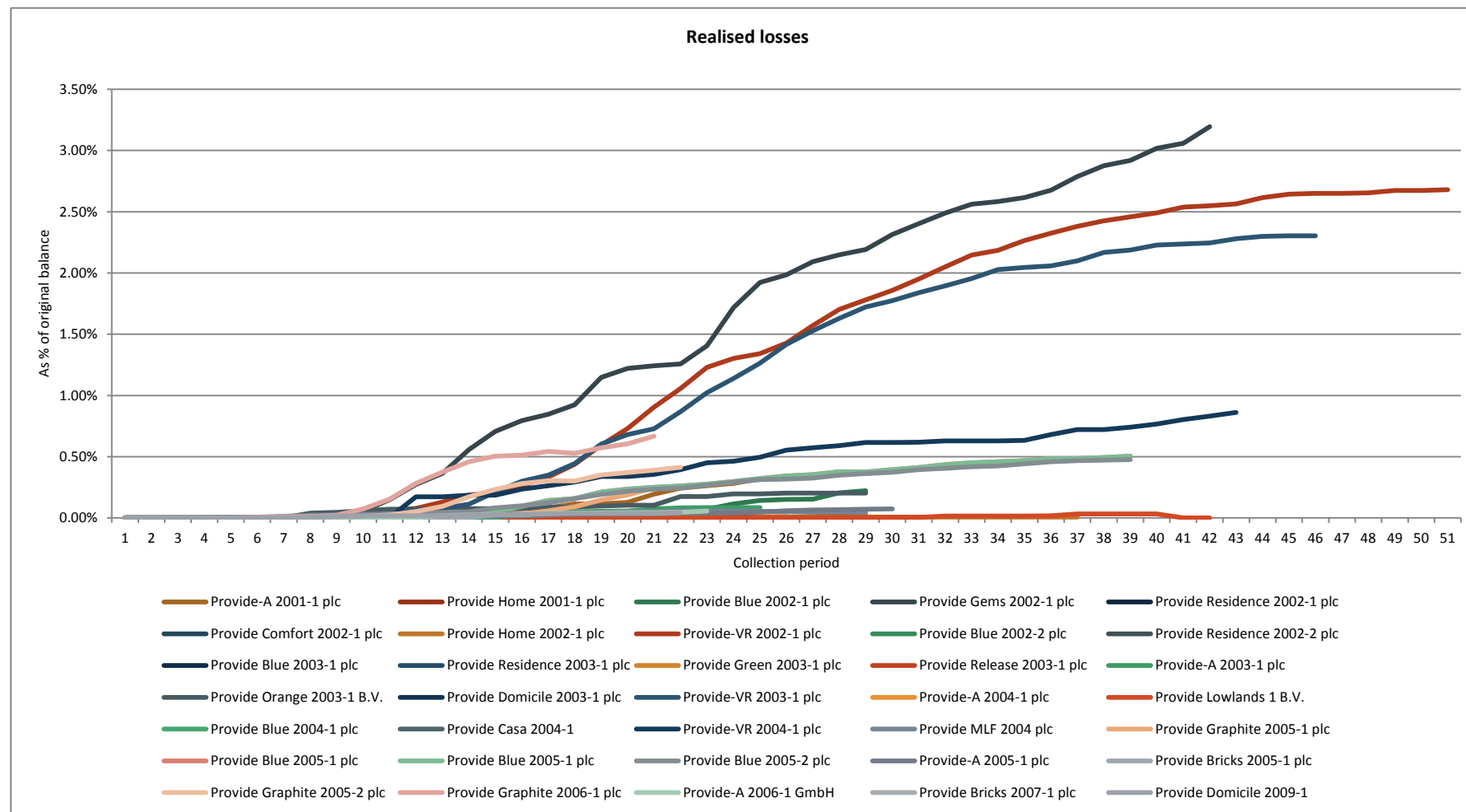
	Seniority	Tranche size	Capital treatment	Numerical example
Retained (5% vertical slice)	Senior retained	93.5%	Supervisory formula	<p>Transaction Parameters</p> <ul style="list-style-type: none"> IRB bank with capital ratio of 13.5% / Bis Ratio of 8% Portfolio EUR 1.0bn (with 2 years replenishment / 3 years WAL) 1Y PD: 1.0% LGD: 45% Expected Loss: 0.45% Risk Weighted Assets: 70% (including SME supporting factor 0.76) Kirb=6.05% (= 70% x 8% + 0.45%) <p>Regulatory capital outcome:</p> <ul style="list-style-type: none"> Capital consumption pre-transaction: EUR 94.5m (= EUR 1bn x 70% x 13.5%) Capital consumption post-transaction: EUR 38.8m (= EUR 30m + (935m x 7% (RW) x 13.5%)) Capital Reduction: EUR 55.7m (= EUR 94.5m – EUR 38.8m) = 58.9% Capital Relief Gross Total Cost of Capital (on day 1): 3.5% p.a. (= (EUR 35m x 5.5%) / EUR 55.7)
	Mezzanine Guaranteed	3.5%	Capital relief due to guarantee	
	Junior Retained	3%	Full deduction (1250% risk weight)	



Table 1: Lifetime default rates and average change in credit quality SME CLOs, RMBS and German subsamples (source: S&P as of 2014)

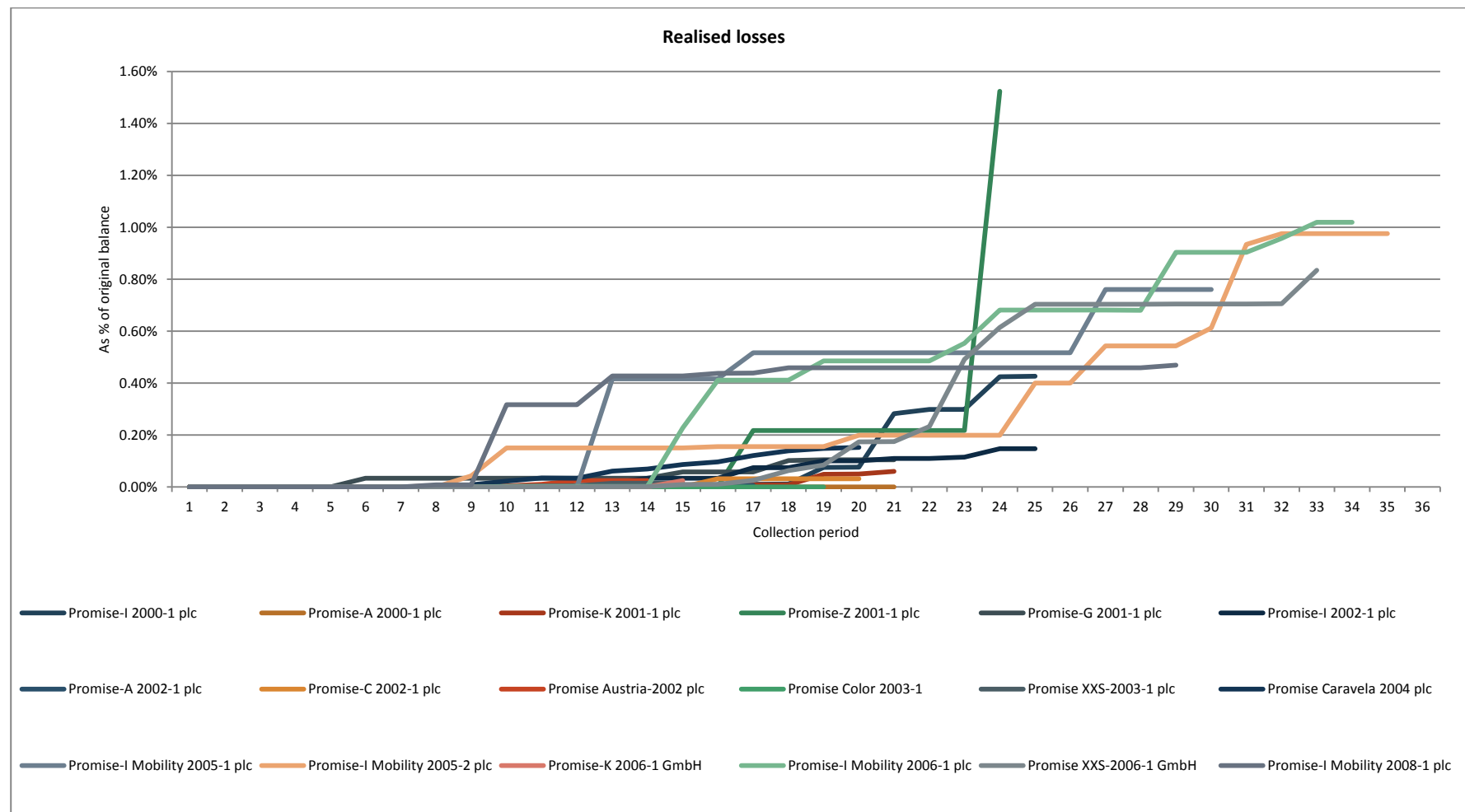
Sector	Share of sector in synthetic format (%)	Lifetime upgrade rate (%)		Lifetime downgrade rate (%)		Lifetime default rate (%)		Lifetime average change in credit quality (no. of notches)	
		Synthetic	True sale	Synthetic	True sale	Synthetic	True sale	Synthetic	True sale
SME CLOs	29	22	7	23	54	0	10	-0.6	-3.2
German SME CLOs	54	27	2	19	63	0	29	-0.8	-7.1
RMBS	7	19	8	8	35	1	2	-0.0	-1.6
German RMBS	81	27	6	6	56	1	4	0.2	-4.0

Figure 18: PROVIDE RMBS transactions¹³ (mostly DE) – Historical loss performance



¹³ 34 transactions: aggregate original balance EUR 63 billion.

Figure 19: PROMISE SME transactions¹⁴ (mostly DE) – Historical loss performance



¹⁴ 18 transactions: aggregate original balance EUR 32 billion.

Box 3

Admitted credit events under a sample guarantee contract:

- a) After the expiration of the later of:
- i. any applicable Grace Period (after the satisfaction of any conditions precedent to the commencement of such Grace Period), and
 - ii. [●] calendar days from the due date for payment,

the failure by the Reference Entity under the Reference Obligation to make, when due, any payment of principal or interest in an aggregate amount of not less than EUR [●] [(excluding late payment or default interest)] in accordance with the terms of such Reference Obligation (a “**Failure to Pay**”), where “Grace Period” means, in respect of any Reference Obligation, the applicable grace period with respect to payments under the relevant Reference Obligation under the terms of such Reference Obligation in effect as of the later of the Effective Date and the date on which such Reference Obligation was included in the Reference Portfolio;

- b) a **Bankruptcy** (ISDA 2002 definition) in respect of the Reference Entity;
- c) the repayment obligations under a Reference Obligation **are restructured by agreement** between the [Bank] and the Reference Entity in circumstances where in the absence of such restructuring either a Failure to Pay or a Bankruptcy would occur and the Bank accounts for a Loss in respect of such Reference Obligation following such restructuring (a “**Restructuring**”)[or]
- d) a classification of a Reference Obligation by the [Bank] **as a defaulted Loan** in compliance with the Credit and Collection Policies (consistently applied), as a consequence of which the Bank shall (immediately or in the future) account for a Loss with respect to such Reference Obligation;

Box 4

Admitted early termination events under a sample guarantee contract:**The protection seller (guarantor) can claim early termination if:**

- a) A **bankruptcy** (ISDA 2002 definition) occurs in respect of the beneficiary;
- b) The beneficiary fails to pay a **credit protection fee** [...]
- c) The beneficiary **fails to fulfil its material contractual obligations** [...]
- d) The guarantor objects to an amendment of the beneficiary’s **Credit and Collection Policies** [...]
- e) A **servicing termination** event occurs;
- f) An **illegality** occurs in respect of the beneficiary’s obligations;

The protection buyer (beneficiary) can claim early termination if:

- a) The protection seller **fails to pay** any of the due credit protection payments [...]
- b) The guarantor **fails to fulfil its material contractual obligations** [...]
- c) A **tax event** occurs on any payment due [...]
- d) A **regulatory change** occurs [...]
- e) The **reference portfolio notional falls** below X% of initial portfolio [...]
- f) An **illegality** occurs in respect of the beneficiary’s obligations [...]

Automatic early termination date occurs when the beneficiary incurs bankruptcy.

Box 5

Early termination events under the ISDA 2002 Master Agreement:

- a) **Illegality;**
- b) **Force majeure event;**
- c) **Tax event;**
- d) **Tax event upon merger;**
- e) **Credit event upon merger;**
- f) **Event of default**
 - a. Failure to pay or deliver;
 - b. Breach or repudiation of agreement;
 - c. Credit support default;
 - d. Misrepresentation;
 - e. Default under specified transaction;
 - f. Cross-default;
 - g. Bankruptcy;
 - h. Merger without assumption;



EUROPEAN BANKING AUTHORITY

Floor 46 One Canada Square, London E14 5AA

Tel. +44 (0)207 382 1776

Fax: +44 (0)207 382 1771

E-mail: info@eba.europa.eu

<http://www.eba.europa.eu>