CLIFFORD CHANCE

Briefing note

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EBA Report on Synthetic Securitisation

In the latest development in the continuing reform of securitisation in the EU, the EBA has recommended modifications to the proposed amendments to CRR to provide for preferential regulatory capital treatment for the senior retained tranches of certain synthetic securitisations of SME exposures.

Synthetic Securitisation and the STS Framework

On 30 September 2015, the European Commission published the draft text of the proposed Securitisation Regulation and accompanying amendments to the Capital Requirements Regulation (CRR), to introduce a preferential regulatory treatment for simple, transparent and standardised (STS) securitisations within the EU. The STS framework proposed in the draft Securitisation Regulation effectively excludes synthetic securitisations because they do not involve a true sale of the securitised exposures from the originator to the securitisation issuer.

The only exception to this is set out in Article 270 of the CRR amendments, which provides for an originator to calculate the risk-weighted exposure amounts in respect of a synthetic securitisation position as if it were a STS securitisation in certain limited circumstances, the key requirements being that the securitisation relates to SME exposures and that the credit protection is provided by an EU government, central bank, multilateral development bank or international organisation that qualifies for a zero per cent risk weighting under CRR.

Over the past few months, the European Banking Authority (EBA) has been engaged in a consultation process considering whether or not the STS framework should be extended to include some types of synthetic securitisation and on 18 December 2015 it released a report containing its recommendations in this respect. In the report, the EBA has not recommended extending the STS framework to include synthetic securitisations. It has, however, recommended some modifications to the proposed Article 270 of the CRR amendments to extend its scope to encompass a broader range of synthetic securitisations.

The EBA's report is based in part on the results of an information gathering exercise which it has undertaken with various market participants.

In its report, the EBA made a number of observations, including:

- Over 90 per cent of synthetic securitisation issuance in the period between 2008 and 2014 involved protection provided by investors other than entities of the types referred to in the existing draft of Article 270.
- Default rates for SME synthetic securitisations over the same period have been extremely low (and zero in relation to retained senior tranches).
- Where cash collateral is held on deposit with the protection buyer, the CRR already provides for a zero per cent risk weighting on the credit protection.

These observations appear to form the basis of the EBA's recommendation that the scope of Article 270 therefore be expanded to include some types of SME synthetic securitisations.

Key issues

- The EBA has proposed modifications to Article 270 of CRR to provide for STS-like capital treatment for the senior retained tranches of certain SME synthetic securitisations.
- The securitised exposures and protection must be denominated in a single currency.
- Protection from non-public entities must be cash collateralised.
- No changes to significant risk transfer requirements.

Key Features

The EBA recommendations recognise that a synthetic securitisation can take many forms, including bilateral risk transfer transactions between an originator and protection seller which do not involve a special purpose vehicle or the issue of any securities.

The key features of the EBA recommendations are as follows:

- **Balance sheet transactions only:** As widely anticipated, the EBA proposals only apply to what are commonly referred to as "balance sheet" synthetic securitisations, where the protection buyer is securitising exposures originated within its group, and where the transaction is entered into in order for the protection buyer to manage its credit risk and regulatory capital requirements in connection with those exposures. "Arbitrage" synthetic securitisations, entered into for speculative purposes, are excluded.
- **Only applies to senior retained tranches:** The preferential treatment provided by Article 270 would apply only to the senior tranches of a synthetic securitisation which are retained by the originator. It does not, therefore, apply to any securitisation position which is sold to or otherwise placed with a third party investor. However, as the trend since the introduction of Basel II has been for originators to retain the senior tranches, and as the main third party investors in synthetic securitisations in recent years have been hedge funds and pension funds which are not themselves subject to prudential capital requirements, this is unlikely to present a major concern to current market participants. This limitation will, however, make it comparatively more expensive for banks to invest in synthetic securitisations originated by other banks.
- **Only SME exposures:** The securitised exposures should be classified as exposures to SMEs, as defined in Article 501 of CRR. This is perhaps the most significant limitation in the EBA proposals. In recent years, SME synthetic securitisations have represented approximately one third of overall market volumes, and this is an asset class which is often difficult to securitise using traditional true sale securitisation. However, by far the largest asset class, representing over 50% of all synthetic securitisation issuance, is large corporate loans, and these securitisations would be excluded under the EBA's proposals.
- **Single currency exposures:** The securitised exposures must be denominated in the same currency, which must also be the currency in which the protection is denominated. This is also a significant limitation, and is likely to be particularly problematic for banks outside the eurozone (other than the UK), which may find it difficult to attract investment in their local currency. Even for banks within the eurozone, the inability to combine assets denominated in multiple currencies into a single securitisation is a significant limitation.
- **Single governing law:** The securitised exposures must be governed by the laws of a single legal system. This limitation appears to be a hangover from the STS requirements for traditional securitisation, where requiring the securitised exposures to be governed by a single legal system simplifies the true sale process. This should be much less of a concern in a synthetic securitisation where no such true sale is required.
- **Cash collateral:** Unless the protection seller is a public sector entity which qualifies for a zero per cent risk weighting under CRR, the protection seller must collateralise its obligations to the originator with cash placed on deposit with the originator. While most investors are already accustomed to providing cash collateral, the desire to limit their credit risk to the originator institution has seen an increasing trend for cash to be held either with a third party bank or in the form of high quality securities. While the EBA proposals do not appear to prevent the originator from itself providing collateral for its obligation to repay the deposit, this adds complexity to a transaction.
- **Sequential amortisation:** As securitised exposures mature or amortise, tranches in the securitisation must amortise sequentially in order of seniority. Pro-rata amortisation is not permitted. This requirement goes against a developing trend in synthetic securitisations in recent years which has seen an originator preference for all tranches to amortise pro-rata, after taking accrued losses into account.

STS Securitisation by another name?

The securitisation must also satisfy various additional requirements which are based closely on the requirements for traditional term STS securitisations set out in the draft Securitisation Regulation. These include requirements in relation to origination processes, asset eligibility and selection, servicing, risk retention, transaction management and reporting. However, certain modifications have been made to those requirements to address structural differences between traditional securitisations and synthetic securitisations, such as the absence of a true sale of the securitised exposures in a synthetic securitisation, and the need to prescribe the credit events and valuation principles which determine the protection payments due to the originator following a default in the securitised exposures.

These additional criteria include the following:

- **Compliance with Credit Risk Mitigation rules:** The credit protection agreement, which may be in the form of a credit default swap, guarantee or credit-linked note, must comply with the requirements for credit risk mitigation (CRM) in Chapter 4 of CRR.
- **Credit Events:** In addition to complying with the CRM requirements, the credit protection must provide for protection payments to be made following a failure to pay, bankruptcy or restructuring of the securitised exposures within the meaning of Article 178 of CRR.
- **Realised Loss:** The credit protection payments must be based on the actual realised loss suffered by the originator of the securitised exposure. Where necessary, an interim protection payment must be made not more than one year after the occurrence of the credit event.
- **Verification:** A third party verification agent is required to verify the occurrence of credit events, that a defaulted exposure satisfied the eligibility criteria, and the calculation of the credit protection payments.

Other than as outlined above, the additional requirements that have been prescribed are largely consistent with the features commonly seen in synthetic securitisations in recent years.

Continuing Challenges

As with the application of the STS framework to traditional true sale and ABCP securitisations, a number of the STS-based criteria which would apply under the EBA proposals are also problematic for synthetic securitisations. In particular, restrictions on including exposures from obligors which have been subject to a restructuring within the preceding three years, and a requirement that exposures to any individual underlying obligor may not exceed one per cent of the securitised portfolio, will limit the scope of exposures which banks can seek to manage using synthetic securitisation, although the impact of some of these limitations may be less significant in light of the exclusion of non-SME exposures as outlined above.

The EBA proposals do not address the requirements for achieving significant risk transfer (SRT), revised rules for which are set out in the proposed CRR amendments, and which remain a pre-requisite for an originator being able to apply the securitisation risk weightings to any tranches which it retains in a synthetic securitisation. Although the EBA proposals have been drafted so as not to prevent a synthetic securitisation from meeting the requirements for SRT, whether or not an individual transaction does so will continue to be determined by the applicable national regulators, along with the ECB, so it is likely that the differing approaches to matters such as the availability of originator calls and the use of synthetic excess spread will continue.

Next Steps

Whether or not the EBA recommendations are adopted by the Commission in some form as part of the amendments to CRR accompanying the Securitisation Regulation remains to be seen. If they are adopted by the Commission, they must then be considered by the EU Parliament and the Council of the European Union, and an agreed text be approved by all three before the proposals would become law. None of these matters is certain, and it is, of course, possible that at any step along the way, further amendments could be made to the EBA proposals. If the recommendations are adopted, it is likely that they would come into effect at the same time as the other amendments to CRR, which is unlikely to be much before the end of 2017.

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