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THE EBA PUBLISHES ITS REPORT ON THE CREATION OF AN STS FRAMEWORK FOR SYNTHETIC SECURITISATIONS

The European Banking Authority has published its report on the feasibility of extending the STS Securitisation Framework to synthetic securitisations. In the report, the EBA has proposed a set of criteria for synthetic STS securitisation-limited to balance sheet synthetic securitisations – and indicated how originators could benefit from a more favourable regulatory capital treatment for such transactions. It has, however, left it up to the European Commission to decide whether to proceed with such differentiated treatment. This briefing discusses the key issues arising from the report.

Key issues

- The EBA has proposed extending the STS Securitisation Framework to include balance sheet synthetic securitisation.
- Proposed criteria for synthetic STS securitisation are closely modelled on the criteria for traditional securitisation currently set out in the EU Securitisation Regulation.
- Additional criteria have been proposed to address specific structural features of synthetic securitisations.
- The EBA has also set out how a differentiated regulatory capital treatment could apply to the senior tranche of synthetic STS securitisations which are retained by the originator, but has left it to the European Commission to decide whether to implement such treatment.

BACKGROUND

On 6 May 2020, the European Banking Authority published its long-awaited Report on whether the "simple, transparent and standardised" ("**STS**") framework for securitisations in the EU should be extended to synthetic securitisation[1] (the "**Report**"). When the STS framework was introduced in the EU Securitisation Regulation ("**EUSR**") at the end of 2017, synthetic securitisation was excluded from this regime, reflecting the fact that the corresponding "STC" securitisation framework in the Basel Accord is limited to traditional (or true sale) securitisation.

However, although synthetic securitisation was excluded from the STS framework in 2017, Article 45 of the EUSR did contain a requirement for the EBA to publish a report on the feasibility of extending the STS framework to synthetic securitisation so as to enable to the European Commission to consider whether to prepare a legislative proposal to that effect. This is that report.

The Report is also the latest development in a series of papers released by the EBA over the past few years, beginning with the EBA Report on Synthetic Securitisation in December 2015 (the "**2015 Discussion Paper**"), in which the EBA first set out a set of potential STS criteria which could apply to synthetic securitisation. In that report, the EBA also recommended that the differentiated capital treatment which applies to traditional STS securitisation be extended to some SME synthetic

1 https://eba.europa.eu/sites/default/documents/files/document_library/News%20and%20Press/Press%20Room/Press%20Releases/2020/EBA%20proposes%20Framework%20for%20STS%20Synthetic%20Securitisation/883430/Report%20on%20framework%20for%20STS%20syntetic%20securitisation.pdf

securitisations, a recommendation which was adopted in Article 270 of the EU Capital Requirements Regulation ("**CRR**") when the EUSR was introduced in 2017.

The EBA Report

The Report was preceded by a discussion paper released by the EBA in September 2019 (the "**2019 Discussion Paper**"), and takes into account responses received from stakeholders during the 2-month consultation period. In the report, the EBA discusses the way in which the balance-sheet synthetic securitisation market has grown over the past 10 years, such that it is now being used by a large number of banks across the EU as part of their credit risk and capital management strategies. In particular, the EBA discusses how synthetic securitisations have performed, with very low loss rates across all asset classes. The EBA also recognises in the report that synthetic securitisation has an important role to play in enabling banks to manage their credit and capital requirements for exposures which are not well-suited to traditional securitisation, either because of the nature of the exposures (such as large corporate loans) or because of issues which may prevent achieving a true sale (such as the geographic spread of the exposures or confidentiality concerns). Finally, the EBA emphasises how the enhanced regulatory environment which now applies to all EU securitisations under the EUSR has gone a long way to redressing what had previously been perceived concerns with synthetic securitisation.

Based on the analysis conducted, the EBA recommends that it is now appropriate to extend the STS framework to include balance sheet synthetic securitisation. As was the case in the 2019 Discussion Paper, the EBA continues to apply a "two stage" approach to applying the STS framework to synthetic securitisations. The first stage involves the creation of a "best practice" STS securitisation product, while the second stage involves consideration of whether to apply a differentiated regulatory capital treatment of such an STS product.

In respect of the first stage, the Report sets out a set of criteria for synthetic STS securitisation. These criteria are explicitly modelled closely on the criteria for traditional STS securitisation set out in the EUSR so as to ensure as much consistency across the "STS" label as possible. However, some of the traditional STS criteria which cannot be applied to synthetic securitisation (such as the requirement for a true sale, or hedging of interest and currency risk) are excluded or modified. At the same time, some additional criteria are proposed to reflect features of synthetic securitisation which do not arise in traditional securitisation. These include requirements to mitigate the counterparty credit risk that is inherently involved in synthetic securitisations, requirements addressing various structural features such as the scope of credit events and methods for calculating loss payments, and, perhaps most importantly, requirements ensuring that the framework only applies to balance sheet synthetic securitisation, and not to arbitrage synthetic securitisation.

In respect of the second stage, in the 2019 Discussion Paper, the EBA stopped short of recommending whether or not a differentiated regulatory capital treatment should apply to synthetic STS securitisation, instead opting to set out the pros and cons of such an approach. The EBA has essentially retained this approach in the Report, although it has taken the analysis one step further by recommending what such a differentiated capital treatment could look like, and recommending that if any such treatment is introduced, it should be accompanied by a mandate for the EBA to monitor the functioning of the synthetic STS market. This approach may partly be due to a perceived limitation in the EBA's mandate under Article 45 of the EUSR, which relates only to the feasibility of extending the STS framework to balance-sheet synthetic securitisation, and not to potential changes to the capital treatment for such

securitisations, which is instead addressed in the CRR. It will ultimately be for the European Commission to consider the relevant pros and cons and decide whether or not the introduction of a differentiated regulatory capital treatment for STS balance sheet synthetic securitisation is indeed justified at this stage.

Criteria for STS Synthetic Securitisation

The Report sets out 35 proposed STS criteria for synthetic securitisations. These criteria are spread across four areas, i.e. “Simplicity” (Criteria 1-12), “Standardisation” (Criteria 13-22), “Transparency” (Criteria 23-27), and, finally, “Requirements specific to synthetic securitisations” (Criteria 28-35). The criteria broadly follow what had been originally suggested in the 2019 Discussion Paper, but, with a number of refinements which reflect many of the responses received from stakeholders during the consultation period.

Some of the key changes as compared to the criteria originally proposed in the 2019 Discussion Paper are as follows:

- ***Currency and interest rate risk (Criterion 14)***: The EBA has removed the proposal originally included in the Discussion Paper, pursuant to which the protection buyer should bear no currency or interest rate risk in relation to the underlying exposures, and instead merely requires that the transaction documentation must describe how any such risks may affect payments to the protection buyer and investors. This change reflects the underlying structure of most existing synthetic securitisations where, because payments to investors are not funded from the cashflows received on the securitised exposures, investors are not exposed to risks arising from movements in currency or interest rates in the same ways as they are for traditional securitisations.
- ***Hybrid amortisation (Criterion 17)***: The EBA has made a very helpful clarification in respect of Criterion 17 by clarifying that both pro-rata and "hybrid" amortisation structures (whereby some tranches may amortise pro-rata while others amortise sequentially) are permitted, provided that appropriate triggers are included to switch to full sequential amortisation following deterioration in the credit quality of the underlying exposures.
- ***Excess spread (Criterion 34)***: Perhaps the most important difference between the 2019 Discussion Paper and the Report relates to synthetic excess spread. The 2019 Discussion Paper originally prohibited its use. However, in the Report, the EBA does permit the use of synthetic excess spread, provided that the amount of excess spread available in a given year does not exceed the one-year expected losses on the portfolio, and that such excess spread can only be applied on a "use it or lose it" basis in respect of losses which occur in each payment period.
- ***Collateral arrangements (Criterion 35)***: The EBA has revised the criteria regarding collateral arrangements to allow collateral in the form of cash to be held on deposit with the protection buyer, subject to a minimum credit quality standing requirement. Criterion 35 also provides that this requirement would be deemed to be satisfied in the case of credit linked notes issued by the originator, in accordance with Article 218 of the CRR. This approach is welcomed as it is more aligned with current market practice, where the majority of synthetic securitisations involve the transaction being structured either with the collateral held on deposit with the protection buyer or in the form of an unsecured credit-linked note issued by the protection buyer. However, the EBA has also retained the requirement that where collateral is in the form of securities, those must be

short-dated 0% risk weighted, thereby effectively limiting such collateral to government or international financial institution (IFI) securities.

One change which the industry had hoped to see, but which has not been included in the extension of the scope of eligible credit protection to include unfunded protection provided by private sector protection sellers, such as insurers. As was the case in the 2019 Discussion Paper, unfunded protection is limited to protection providers that qualify for a 0% risk weight under the CRR, which essentially means government or IFI entities. This outcome was not unexpected, however, given that the EBA had clearly expressed its view in the 2019 Discussion Paper, and again in the Report, that mitigating counterparty credit risk for both the originator and investors is an important consideration for synthetic STS securitisation.

Framework for a Differentiated Regulatory Treatment of STS Synthetic Securitisation

The proposed criteria for synthetic STS securitisation set out in the 2019 Discussion Paper were generally well-received by the industry, albeit that some fine tuning was required to ensure that they were workable, much of which has now been reflected in the revised criteria set out in the Report.

However, what market participants have been most concerned about, and emphasised in their responses to the 2019 Discussion Paper, is the importance of extending the reduced STS risk weights to synthetic STS securitisation in the same way as for traditional STS securitisation. As noted above, the EBA has again stopped short of recommending such differentiated regulatory capital treatment. However, the Report nevertheless constitutes a significant development because the EBA has set out how such differentiated regulatory treatment could work if it was introduced.

The EBA proposes such treatment would be limited and targeted in scope and would not be extended to a fully-fledged cross-sectoral preferential regulatory treatment for synthetic securitisations, although it does not actually provide any colour as to which sectors should or should not benefit from such treatment. In terms of content, it would consist of an adjustment of the prudential floor for the senior tranche retained by the originator to the level applicable under the STS traditional framework and corresponding adjustments of the risk weights for the senior tranche as applicable under the STS traditional framework.

Finally, the EBA specified a number of conditions for differentiated regulatory capital treatment to apply to STS balance-sheet synthetic securitisations. In particular, such treatment would apply only to the most senior tranche in the synthetic securitisation, and would only be available to the originator which retains such position. The securitisation would also need to satisfy the criteria under Article 243(2) in the same way as for traditional STS securitisation.

It is now up to the European Commission to decide whether or not to propose the extension of the STS regime to balance sheet synthetic securitisation and, if so, whether the introduction of a differentiated capital treatment for STS balance sheet synthetic securitisation is justified at this stage.

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