Briefing
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Synthetic securitisation
A closer look

SUMMARY

In September 2015, the European Commission adopted two legislative proposals: one that aims to develop an EU-wide framework for simple, transparent and standardised (STS) securitisations, and another that aims to make the capital treatment of securitisations for banks and investment firms more risk-sensitive by amending the Capital Requirements Regulation (CRR). While the European Commission did not include synthetic securitisations in the STS scheme, it left open the possibility for some of them to be included at a later stage. Similarly, while synthetic securitisations in general do not benefit from a different prudential treatment under the CRR, the Commission proposed that a specific category of synthetic transactions should – under specific conditions – benefit from an equivalent regime.

The European Banking Authority (EBA), the Council of the EU and the European Central Bank (ECB) have all given their views on the matter and the debate has yet to conclude, as the two proposals are under discussion in the European Parliament's Committee on Economic and Monetary Affairs. The question of synthetic securitisations benefiting from a specific regime carries opportunities (by broadening the market for originators and freeing up capital to finance the real economy, notably SMEs) as well as risks, depending on the synthetic securitisation used and the final framing of the regime. Hence, this briefing gives a general introduction to the subject and outlines the positions of the Commission, the Council, the EBA and the ECB.

In this briefing:

- Introduction
- Basics of credit derivatives used in synthetic transactions
- Main types of synthetic securitisations
- Market overview
- How does a (funded) balance sheet synthetic transaction work?
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Glossary

Credit risk: the risk that a party to a transaction will not settle the full value of an obligation – neither when it becomes due nor at any time thereafter.

Credit event: an event that triggers credit protection payments from the protection seller to the protection buyer within a credit protection contract. Typical credit events include failure to pay after 90 days and restructuring/bankruptcy of the credit/obligor.

Exposure: the condition of being at risk of financial loss.

Financial guarantee: a bilateral contract whereby the guarantor pays the sums due by the debtor on the failure of the latter to pay.

Premium: the amount paid by the protection buyer to the protection seller for buying protection against losses.

Regulatory capital: the amount of capital a bank is required to hold to protect itself from potential losses.

Regulatory capital relief: the reduction in the amount of capital a bank is required to hold; here, this reduction is achieved through the credit protection obtained through the derivative.

Tranche: a portion of a structured finance instrument, with particular risks, rewards and/or maturity. 'Tranche subordination' refers to the hierarchy of claims of each tranche.

Sources: ECB, EBA, Merriam-Webster, AFME, Investopedia, Malta FSA, NY Fed.

Introduction

According to Article 4 of the Capital Requirements Regulation, securitisation is 'a transaction or scheme, whereby the credit risk associated with an exposure, or a pool of exposures, is tranched, having both of the following characteristics: payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme'.[1] Depending on the method used for transferring risk, securitisation is categorised as either traditional or synthetic.

Traditional securitisation involves the effective legal transfer of the assets to the issuer of the securities (the securitisation special purpose entity – SSPE); as a result, the underlying assets are removed from the originator's balance sheet and the SSPE becomes entitled to the cash flows that are generated by those assets. Therefore, in traditional securitisation, there must be an SSPE and securities must be issued.

In **synthetic** securitisation, the ownership of the securitised exposures remains with the originator (that is, the exposures remain on the balance sheet) and the credit risk is transferred with the use of credit derivatives or financial guarantees. Therefore, neither the SSPE nor the issuance of securities are necessary in this type of securitisation (although they will be included in the example given below).

Basics of credit derivatives used in synthetic transactions

A **derivative** is a financial contract where the payment obligations of the parties are derived from another set of assets or liabilities. A **credit derivative** is a financial contract between two parties that allows them to isolate credit risk from the underlying asset/liability and transfer it – for a premium – from one party to another.

The **payment obligation** in a credit derivative is defined by reference to the performance of a third party (the 'reference entity') or a specific obligation (the

'reference obligation'). The event that triggers this obligation is called a **credit event**.[2] The parties to the transaction are the **protection buyer**, that is, the party which wants to transfer the credit risk and is entitled to payment if the credit event occurs (in the case of synthetic securitisation, this is usually the originator of the exposures) and its counterparty, the **protection seller**. Finally, credit derivatives are written for a **notional value**, which is defined as 'the value of the reference asset with reference to which a credit derivative contract is entered into'. This notional value forms the base used for defining the premium to be paid by the protection buyer and the payment to be made upon the occurrence of a credit event by the protection seller(s).

Funded and unfunded credit derivatives

Unfunded credit derivatives are bilateral, privately negotiated credit derivatives contracts. They are described as unfunded because the seller makes no upfront payment to cover his potential future liabilities, but will make a payment only if the conditions of settlement are met. This implies that the buyer takes a credit risk on whether the seller will be able to pay any settlement amount – that is, he is exposed to (counterparty) credit risk.

A type of an unfunded credit derivative is the **credit default swap (CDS)**, defined as 'a bilateral financial contract between two parties ... with reference to a certain notional value, referenced to the reference obligations of a reference entity, whereby the former pays a premium to the latter, expressed in basis points point per annum on the notional value, usually paid quarterly in arrears, and in return, the latter agrees to make certain protection payments to the former, contingent upon the occurrence of a credit event with respect to a reference entity'.

In plain terms, in the case of such a derivative, the protection buyer pays a fee to the protection seller to protect the financial loss arising from the default or other credit event of a reference asset (a bond, a portfolio of bonds). If the credit event does happen, after a 'cooling down' period, the protection seller pays the protection buyer:

- either the par value (that is, the outstanding principal plus accrued interest on the notional amount);
- or the difference between the par value and the market value of the reference obligation which has suffered the defined credit event.

For example, suppose Bank A and Bank B enter into a CDS contract. Under the terms of the contract, Bank A pays Bank B 10 basis points (0.1%) on a €1 000 000 contract every quarter for five years. If a credit event occurs during the period and the market price of the reference asset(s) drops to €750 000, then Bank A will get €250 000 from Bank B (€1 000 000 – €750 000).

In contrast, **funded** credit derivatives involve the issue of a debt obligation either by a SSPE or a bank, which is then purchased by (one or more) protection sellers. There is thus an upfront payment to the protection buyer, who has no counterparty risk exposure.

A type of a funded credit derivative is the **credit-linked note (CLN)**, defined as 'a note, or an obligation of an issuer, subscribed to by an investor, that carries an embedded credit derivative (for instance, a CDS), whereby the amount payable on the note – that is, principal, coupon, or both – may be written down, based on the protection payments required under the credit derivative'.

The CLN therefore allows a CDS to be incorporated into an investment product and to be sold to investors in the capital markets. In the previous example, Bank A, issues CLNs for the nominal value of €1 000 000. These CLNs will pay the CDS premium (that is, 0.1%), as well as an extra 'premium' for the investors (for instance, 0.05%), hence a total coupon of 0.15%.

The investors will buy the CLN, that way providing upfront funding to the issuer to the extent of €1 000 000. Over time, Bank A will be paying investors the coupon on the notes. In case of one or more credit events, Bank A will use ('write down') the coupon, the principal (or both), to obtain compensation under the contract. Upon maturity of the CLNs, the amount remaining after the losses will be distributed back to the investors.

Main types of synthetic securitisations

Depending on the aims of the transaction, two main types of synthetic securitisations can be identified: balance sheet synthetic transactions (BSST) and arbitrage synthetic transactions (AST).

Balance sheet synthetic transactions

The originator objectives in a BSST include **credit risk management** (large exposure positions and concentration risk[3]) and the related **regulatory capital relief**, as well as benefitting from a structure that is less burdensome and costly from an administrative perspective and less risky from a legal/organisational one (at least when an SSPE is not required).

On the other hand, a synthetic transaction **adds a layer of complexity**, in that – at least in unfunded BSSTs – counterparty risk may arise for the originator in relation to the financial guarantor or swap counterparty (resulting in the lack of credit protection), and vice-versa. Similarly, synthetic securitisation introduces leverage into an originator's balance sheet, as capital requirements are reduced while the securitised exposures remain on the balance sheet.[4]

Types of balance sheet synthetic transactions

As noted earlier, the credit risk of exposures held by an institution on its balance sheet can be transferred to third parties by means of credit derivative instruments or financial guarantees. Where a credit derivative instrument is used, the transaction can be funded (CLN), or unfunded (CDS). Usually, a portfolio of exposures is divided into two or three tranches, with the senior tranche being retained by the originator bank, the mezzanine tranche being the reference obligation of the credit derivative and the junior tranche being either fully retained by the originator or partly retained by the originator and partly 'covered' by cash collateral provided by an investor.

Arbitrage synthetic transactions

As the name implies, the originator objective in an AST is to profit from an arbitrage occurring between the higher spread received on underlying lower credit quality debt or products indices (for instance, the ABX family of indices) and the lower spread paid on the resulting structure and credit-enhanced notes. The different aim to be achieved also defines the party initiating the transaction: while BSST are usually originator-driven, AST are mostly investor-driven and tailored to their needs. Typical securities issued in AST are synthetic collateralised debt obligations.

Market overview

The EBA report provides some interesting data relating to synthetic securitisation, which, after the financial crisis, points to a more cautious approach to securitisation in general and synthetic securitisation in particular.

With regard to **type used and volumes**, available data show the following trend: before the 2008 crisis, European synthetic securitisation peaked in 2004-2005 with volumes above €180 billion and a majority of CDO (arbitrage) securities issued. Issuance almost halved in 2006 and then gradually dropped to zero, with issues of AST decreasing faster than BSST. Following the 2008 crash of the securitisation market, securitisation has re-emerged in the traditional and retained segment, but has not really recovered for synthetic transactions.

With regard to **originator involvement**, there has been a change since the crisis took place: while before the crisis originators used to place super senior tranches (typically the largest tranches of a transaction in terms of volume), after it occurred they started placing only mezzanine (smaller) tranches.

Finally, with regard to the **credit protection mechanism** used, unfunded credit protection was the prevalent credit protection mechanism applied before the financial crisis, whereas funded protection became the dominant mechanism after it occurred.

As far as the **performance of synthetic securitisations** is concerned, the report finds that the default performance of BSST is comparable to that of traditional securitisations for high rating grades, but also that it is even better for BSST in the case of lower rating grades. In contrast, arbitrage synthetic transactions have performed materially worse than both traditional and balance sheet securitisation transactions.

How does a (funded) balance-sheet synthetic transaction work?

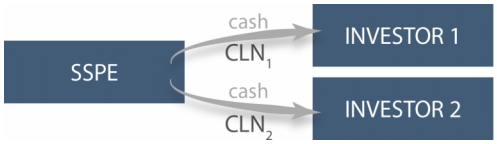
Given the above, the following section focuses on a 'typical' post-crisis synthetic securitisation: a funded, balance-sheet, mezzanine-placing synthetic securitisation.

The process starts with the originator/protection buyer hedging a tranche of risk by entering into a CDS with the SSPE.

Figure 1

The SSPE then issues another credit linked notes which it sells to investors, who assume the mezzanine risk of the portfolio, equal to the notional amount of the CDS.

Figure 2

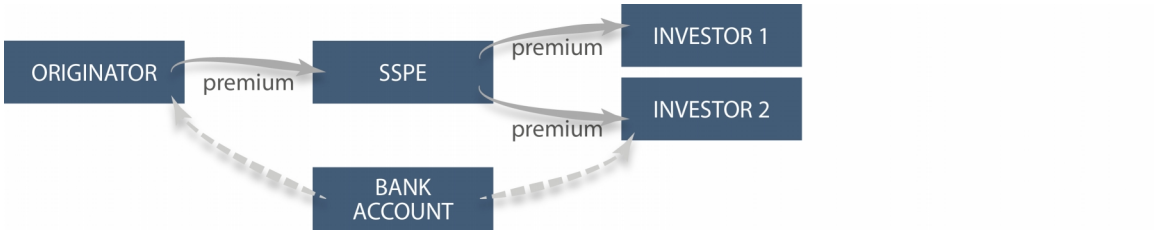


The SSPE deposits the amount received in an account in its name with a bank of a suitably high credit quality (it can also be the originating bank), as collateral. This amount can remain in the account or be invested in a credit risk-free investment. The interest earned by the SSPE on the amount is either given 'back' to the originating bank or passed on to the investors, depending on the deal that was originally struck. Furthermore, given that the coupons promised by the CLNs are going to exceed the

returns from the amount reinvested in risk-free securities, the originating bank pays the SSPE a premium.

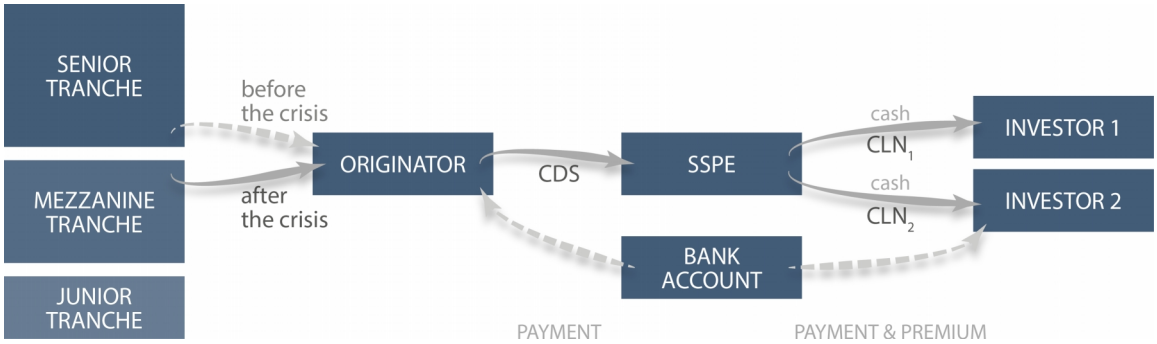
During the life of the transaction, the originator makes payments to the SSPE according to the terms stipulated in the CDS. The SSPE in turn passes on these payment (plus premiums) to the investors under its obligations under the CLN.

Figure 3



Therefore, the complete diagram of a synthetic transaction is as follows:[5]

Figure 4: A funded Balance Sheet Synthetic Securitisation



If the **originating bank fails to meet its premium payments**, the CDS terminates (as does the related CLN). The amount is then returned to investors, who receive the equivalent of an early repayment and are thus protected from the originator's insolvency. If a **credit event occurs**, the originating bank makes a claim under the CDS contract it has with the SSPE, and the SSPE draws on the amount under the CLNs to meet that claim. At maturity, any remaining funds from the CLNs are handed back to the investors.

The current state of the debate

The Commission's proposals

On 30 September 2015, the Commission adopted a package of two legislative proposals. The first is a proposal for a regulation laying down common rules on securitisation and creating a European framework for simple, transparent and standardised (STS) securitisations. In this proposal, the Commission only allows 'true sale' securitisations, but not synthetic transactions, to qualify as STS securitisations. The Commission justifies its position by pointing to the fact that, at the time of adopting its proposals, neither the international standard-setters (for instance, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions), nor the EBA had yet developed STS criteria for synthetic securitisation and there was no consensus on their inclusion in the STS framework. Furthermore, there was insufficient clarity on which synthetic securitisations should be considered STS and under which conditions. It left open the possibility, however, to assess in the future whether some synthetic securitisations that performed well during the financial crisis and are simple, transparent and standardised, should be able to qualify as STS.

The second is a proposal for a regulation amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms. In this proposal, the Commission introduces an exception in Article 270, singling out a specific category (that is, senior positions of SME securitisations that meet certain STS criteria, guaranteed by public authorities or involving public guarantee schemes), which cannot benefit from the STS treatment but could nonetheless be granted a prudential treatment equivalent to STS.

The Council compromise proposal

On 30 November 2015, the Council published its Presidency compromise on the STS proposal. With regards to synthetic securitisations, it adds an Article (29a) to the Regulation, according to which, within six months after its entry into force, the EBA should publish a report considering the eligibility of synthetic securitisations as STS and develop STS criteria for them. Furthermore, the article provides that, by a year after its entry into force, the Commission, taking into consideration the EBA report, should submit a report to the European Parliament and the Council on the eligibility of synthetic securitisations as STS, accompanied, if appropriate, by a legislative proposal.

The EBA report on synthetic securitisation

In December 2015, the EBA published its report on synthetic securitisation, following a consultation process it had been engaged in with stakeholders. In the report, the EBA **does not recommend** extending the STS framework to include synthetic securitisations. **It does**, however, **recommend modifying the proposed Article 270 of the CRR amendments by extending its scope** to encompass a broader range of synthetic securitisations.

The EBA recommends that synthetic securitisations should benefit from this equivalent treatment only if they comply with specific criteria,[6] among which: only synthetic securitisations as defined in Article 242 CRR[7] should be eligible; securitised exposures should be classified as exposures to SMEs; the pool of exposures should be homogeneous; prior to issuance, a sample of underlying assets should be verified by a third, independent party, other than a credit-rating agency; exposures in the pool should be in a single currency; at least one payment should be made by the borrower by the time the security is issued; net economic interest (in accordance with Article 405 CRR) should be retained; and the allocation of losses should proceed in order of seniority.

The ECB opinion

On 11 March 2016, the European Central Bank adopted an opinion on the STS proposal. With regard to the capital treatment for qualifying synthetic securitisations, the ECB acknowledged the cautious approach taken by the Commission.[8] It further pointed out that the prudence of the framework for qualifying synthetic structures should be further strengthened by developing criteria specifically adapted to synthetic securitisations. Nevertheless, the ECB was of the view that the proposed application of the requirements for traditional STS securitisations to synthetic securitisations pursuant to Article 270(a) in the CRR amendment **is not appropriate** in this regard, given the significantly different structural features of traditional and synthetic securitisations. At the same time – referring indirectly to the EBA report[9] – the ECB noted that the introduction of criteria specific to synthetic securitisation transactions **should not expand** the narrow scope proposed by Article 270. Furthermore, the ECB introduced

(Amendment 84) a definition of BSST, to clearly define the type of synthetics qualifying for lower capital charges under Article 270.[10]

Main references

European Banking Authority 'The EBA report on synthetic securitisation', December 2015.

Clifford Chance briefing 'EBA Report on Synthetic Securitisation', December 2015.

Vinod Kothari 'Credit derivatives and structured credit trading', John Wiley & Sons, 2009.

Ian Bell and Petrina Dawson 'Synthetic securitization: use of derivative technology for credit transfer', Duke Journal of Comparative & International Law 541-562, 2002.

Endnotes

1 For an introduction to the subject as well as more for information on 'true-sale' securitisation, see 'Understanding Securitisation: Background – benefits – risks'. For an overview of the Commission proposals as well as of the Council and stakeholder positions, see 'Common rules and new framework for securitisation', for the STS framework, and 'Securitisation and capital requirements', for the proposed CRR amendments.

2 For example, bankruptcy, failure to pay, or restructuring.

3 Exposures that may arise within/across different risk categories of an institution, potentially resulting in losses large enough to threaten its ability to maintain its core operations or cause a material change in its risk profile.

4 It must be mentioned, however, that the leverage ratio regulation, introduced with the CRR, addresses and mitigates the risk of excessive leverage, including the component of the risk that stems from synthetic securitisation.

5 The figure is based on the figure provided by Ian Bell and Petrina Dawson in their article 'Synthetic securitization'.

6 For the complete list of criteria and their rationales, see EBA report on synthetic securitisation.

7 Securitisations, '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'.

8 Whereby 'the preferential treatment is strictly limited to a subset of synthetic securitisation structures'.

9 As mentioned earlier, the EBA report recommends expanding the scope of Article 270, among other things, to allow private investors to act as eligible credit protection providers.

10 See also amendment 113, relating to Article 270(d).

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