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A Move Towards a New STS Framework for Synthetic Securitisations

The EBA's Final Report on the feasibility of a framework for Simple, Transparent and Standardised (STS) Synthetic Securitisations is a cautious step forward.

Key Points:

- The EBA has made a proposal to extend the STS framework to synthetic securitisations in balance sheet form subject to compliance with certain criteria.
- The STS criteria are based on those applicable to STS traditional securitisations, which have been adapted to the synthetic space, with the addition of further criteria reflecting specific features of synthetic securitisations. Certain concerns that market participants raised in response to last year's EBA consultation have been addressed.
- The EBA has also proposed that the European Commission consider implementing a differentiated regulatory capital treatment for senior tranches of balance sheet synthetic STS securitisations, retained by originating banks, and has given the European Commission the tools it requires for making its decision.

Background – how far have we come?

Synthetic securitisations have made a silent comeback since the financial crisis, with policymakers starting to recognize the importance of private transactions in balance sheet form as credit risk and capital management tools that enable banks to free up much-needed lending capacity. In light of the current pandemic, could EU supervisors hail synthetic transactions as one of the products to help the financial sector and the real economy out of the looming economic crisis? A cautious step in that direction can be seen in the recommendations of the European Banking Authority (EBA) in its report published on 6 May 2020 (the EBA Final Report)[1] on the feasibility of the "simple, transparent, and standardised" (STS) framework for synthetics. The EBA has proposed extending the STS framework to balance sheet synthetic securitisations fulfilling certain criteria, has set out its arguments for allowing these transactions to benefit from a more favourable regulatory capital treatment, and has outlined what such differentiated treatment might look like. Ultimately, though, the final decision is left in the hands of the European Commission (the EC).

Until the EC converts the EBA's new proposal into legislation, the STS framework applies effectively only to traditional true-sale securitisations, in which the underlying exposures are transferred by the originator to a special purpose vehicle, that generally issues notes to finance the purchase. In doing so, the exposures are removed from the originator's balance sheet and the special purpose vehicle becomes entitled to the cash flows of such exposures, which the special purpose vehicle passes on to investors in the notes. Depending on the underlying exposures, there are subcategories of true-sale securitisations, such as mortgage-backed securities (MBS) or asset-backed securities (ABS), secured by mortgages, auto loans, consumer loans, or other types of exposures. Synthetic securitisations in balance sheet form are different, in that the exposures remain on the balance sheet of the originating bank, which retains the responsibility for the work-out of any defaulted exposures. Rather than transferring the exposures themselves, the originating bank transfers the credit risk of the portfolio of exposures to a credit protection seller via guarantees or credit derivatives in collateralised or uncollateralised form. If there are defaults in the underlying portfolio, the seller of the credit protection will reimburse the originator for the loss. In return for the portfolio protection, the originator pays a periodic fee. Synthetic securitisations also exist in so-called "arbitrage" format in which the originator does not even own the underlying exposures and holds the credit protection only for arbitrage opportunities. These distinctions underlie the regulatory thought process and the preoccupations with designing an adequate STS framework for securitisations.

The road to an STS framework for synthetic securitisations has been long and winding since December 2015 when the EBA published its Report on Synthetic Securitisation[2]. That report set out for the first time a set of potential STS criteria for synthetic securitisation transactions. The EBA also recommended to extend the differentiated capital treatment applicable to traditional STS securitisations to certain SME synthetic securitisations, a recommendation which was adopted in Article 270 of the EU Capital Requirements Regulation (CRR)[3]. Yet one year later, in December 2016, the Report of the European Parliament's Committee on Economic and Monetary Affairs (ECON) stated explicitly that synthetic securitisations were not eligible for the STS framework, in line with the equivalent STC Securitisation Framework in the Basel Accord adopted in July earlier that year, which did not extend to synthetic securitisations either. Under regulation (EU) 2017/2402 (the Securitisation Regulation)[4] and the wider securitisation framework[5], the STS framework was only available for traditional true-sale securitisations, which may be eligible for preferential regulatory capital treatment if they satisfy the STS eligibility criteria and comply with additional conditions imposed by the CRR Amending Regulation.

However, Article 45 of the Securitisation Regulation required the EBA to develop a report on the feasibility of extending the STS framework to synthetic securitisations — limiting such specific framework to balance-sheet securitisations, which make up the overwhelming majority of the synthetic transactions seen on the European market since the 2008-2009 financial crisis.

On 24 September 2019, the EBA published its discussion paper "Draft Report on STS Framework for Synthetic Securitisation"[6] (the 2019 Discussion Paper) detailing the specific framework and proposing the STS criteria for synthetic securitisations. These criteria were based on those crafted for traditional securitisations adapted to the synthetic universe, with additional criteria to address certain structural features of synthetic securitisations. The EBA Final Report reflects the outcome of that consultation and fulfils the EBA's mandate under the Securitisation Regulation. While the Final Report represents an important step forward, it is by no means the end of the road. Based on the EBA Final Report, the EC, in turn, will submit a report together with a legislative proposal, if appropriate, to the European Parliament and the Council.

EBA Recommendations

The EBA conducted detailed analysis of the recent growth in the market, historic performance data showing very low default and loss rates across transactions, asset classes, and the different types of portfolios on which synthetic transactions are executed (*i.e.* multi-jurisdictional portfolios or core corporate credits for which a true-sale is difficult to implement due to legal complexities, relationships, or confidentiality). In doing so the EBA was able to alleviate concerns that the STS synthetic label may attach to lower performing transactions or “cannibalise” the STS traditional securitisation. The EBA also highlighted that regulatory developments such as the newly implemented Securitisation Regulation created a stringent and comprehensive framework of rules applicable to all securitisation products. As a result, the EBA is now supporting regulatory alignment and consistency between synthetic and traditional securitisation. Therefore, the EBA recommends establishing a cross-sectoral framework for STS synthetic securitisation that is limited to balance-sheet securitisation (and specifically excludes arbitrage synthetic securitisations).

The EBA also recommends compliance with a set of criteria for STS synthetic securitisations that use as a starting point the criteria for traditional STS securitisation set out in the Securitisation Regulation. This alignment of criteria is intended to ensure the highest level of consistency between the two STS regimes. However, a blanket application of true-sale securitisation criteria to balance-sheet synthetic transactions can be problematic. For example, the provisions on STS treatment of synthetic securitisation of SME portfolios under Article 270 of the CRR and the ESMA disclosure templates are difficult to apply to synthetic transactions. As a result, some criteria have been amended or removed altogether (such as the requirement for a true-sale, absence of embedded maturity transformation, or hedging of interest and currency risk) and new criteria have been introduced that are specific to synthetic securitisation to protect both the originator and the investor (addressing counterparty credit risk or relating to structural features such as credit events, credit protection payments, or early termination events).

Last but not least and marking an important step forward compared to the 2019 Discussion Paper, the EBA also opens the door to the possibility of affording favourable capital treatment to senior retained tranches of balance sheet synthetic securitisations. The EBA does so cautiously — not via an outright recommendation, but by urging the EC to consider the pros and cons of introducing such treatment. In order to ensure that, as a result of its better capital treatment, the banks do not overly rely upon STS synthetic securitisation as a capital and risk management tool to the detriment of other tools (such as issuing capital instruments or business model reviews), the EBA also recommends that any potential proposal be accompanied by a mandate to the EBA to monitor the functioning of the STS synthetic market. Thus the fate of a differentiated regulatory capital treatment for balance sheet synthetic STS securitisation passes into the hands of the EC.

Criteria for STS synthetic securitisation

The EBA Final Report proposes 35 criteria for STS synthetic securitisations covering four areas: Simplicity, Standardisation, Transparency, and Requirements specific to synthetic securitisations. The criteria broadly reflect those initially proposed in the 2019 Discussion Paper, with certain amendments reflecting the responses from market participants to the consultation.

Some of the main changes to the criteria originally proposed in the 2019 Discussion Paper are set out below. Unsurprisingly, aside from two early criteria, the changes are mostly in respect of the synthetic securitisation specific requirements (Criteria 28 to 35) that were amended following suggestions from stakeholders.

- **Criterion 14 (Appropriate mitigation of interest rate and currency risk):** The EBA has abandoned the initial requirement in the 2019 Discussion Paper that the protection buyer should bear no currency or interest rate risk in relation to the credit protection it receives. Instead the transaction documentation should clearly describe how any such risks may affect payments to the protection buyer and investors. This change makes sense given the way synthetic securitisations have been structured and have addressed and allocated these risks historically. As protection payments to investors are not funded by cash flows from the underlying reference obligations, the risk for investors is not the same as in traditional cash securitisations and would be difficult to hedge. Therefore, the banks usually assume the risk and account for it in their capital calculations.

- **Criterion 17 (Allocation of losses and amortisation of tranches):** The EBA has clarified that transactions can be structured with both pro-rata and "hybrid" amortisation (*i.e.* comprising a combination of pro rata and sequential amortisation, or pro rata applying to only some tranches). However, this is subject to including clearly specified triggers relating to the performance of the underlying exposures to switch to sequential amortisation. Such performance-related triggers should include at least the deterioration in the credit quality of the underlying exposures below a predetermined threshold. Absent such triggers, sequential amortization should apply. This approach is in line with the concern for maintaining the level of credit protection to cover losses that may crystalise towards the end of the transaction.

- **Criterion 28 (Credit events):** The EBA has excluded restructuring as a credit event if the risk transfer agreement takes the form of a financial guarantee, in order to avoid these being treated as a derivative for accounting purposes, which would give rise to mark-to-market volatility.

- **Criterion 31 (Credit protection premiums):** The EBA has revised this criterion in a helpful way to clarify that the protection buyer would only be required to describe how the protection fee and any note coupons are calculated in respect of each payment date during the life of the securitisation. The 2019 Discussion Paper initially required disclosure to investors of all relevant information used to price the credit protection agreement. Given the set of considerations taken into account in determining what pricing is acceptable from the perspective of both bank and investors, the original criterion would have presented banks with an uncomfortable and impossible task.

- **Criterion 33 (Early termination events):** The EBA added further hurdles that should be met before the early termination following regulatory events can be triggered by the originator. Changes in law, tax, or accounting treatment can only give rise to a right to terminate if the changes have a material adverse effect on the amount of capital that the protection buyer is required to hold in connection with the securitisation, compared with that anticipated at the time of entering into the transaction. Further, such material adverse effect must have been reasonably unforeseeable at that time. This contrasts with the wider and more ambiguous scope initially envisaged in the Discussion Paper, which required a direct impact on the contractual relationship defining the transaction and/or a material impact affecting the allocation of benefits among the parties of the transaction. The final criterion also lists as an independent ground for termination the determination by a competent authority that the protection buyer (or any affiliate of the protection buyer) is not or is no longer permitted to recognise significant risk transfer in respect of the securitisation, in accordance with Article 245 of the CRR.

- **Criterion 34 (Synthetic excess spread):** Important progress was made between the 2019 Discussion Paper and the EBA Final Report in respect of synthetic excess spread. While the EBA recognised that excess spread was widely present in current synthetic securitisation transactions, given that it is a complex structural feature, the EBA initially sought to prohibit the use of excess spread for the sake of simplicity and standardisation. As there was no corresponding prohibition on the use of excess spread in traditional securitisations, and given that many stakeholders disagreed with a complete exclusion of excess spread from STS synthetic securitisation, the EBA's final decision on this criterion was eagerly awaited. The EBA Final Report did not disappoint as it permitted the use of excess spread so as not to substantially limit the use of STS balance sheet synthetics for many asset classes in which such feature is essential (*i.e.* SMEs and consumer lending). However, the use of excess spread is subject to three conditions in order to achieve standardisation and address concerns that excess spread may erode effective risk transfer: (i) the amount of excess spread for each payment period is a fixed percentage of the total outstanding portfolio balance, (ii) excess spread can only be utilised on a "use it or lose it" basis in respect of losses that occur in each payment period (and, if not used in that payment period, the excess spread is returned to the originator), and (iii) the amount of excess spread available per year does not exceed the one-year regulatory expected losses on the underlying portfolio. The final EBA report on significant risk transfer expected before January 2021 will provide further considerations on synthetic excess spread.

- **Criterion 35 (Eligible credit protection agreement, counterparties, and collateral):** The EBA has amended the criteria relating to collateral arrangements to allow cash collateral to be held on deposit with the protection buyer, subject to a minimum credit quality standing requirement. This means that, if the protection buying bank ceases to satisfy that minimum credit quality standing, the bank is required to either transfer the cash collateral to a third-party bank with a minimum credit quality or to invest the cash collateral in high-quality securities. 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. The revised criterion is welcome news as it reflects current market practice. However, if collateral is in the form of debt securities, such securities must have a 0% risk weight and a short maturity of maximum three months, which restricts the eligible universe to instruments issued by governments or international financial institutions.

There are also a number of amendments that stakeholders had requested in their responses to the consultation and that the EBA has not made. Two important points are highlighted below:

- **Criterion 30 (Credit protection payments following the close out/final settlement at the final legal maturity of the credit):** The EBA has capped at two years the extension period for the work-out process of defaulted exposures following a scheduled or early termination of the credit protection agreement. While a two-year period is common, the work-out process may take longer for certain asset classes (such as project finance and real estate), or in certain jurisdictions. Therefore, stakeholders hoped that a hard cap would be abandoned in favour of setting out clearly in the transaction documentation the duration of such extension period and how residual losses should be determined if the work-out process was not finalised by the end of such period. The EBA's approach to cap at two years stems from a concern to ensure a minimum degree of timeliness in credit protection payments and increase legal certainty for investors regarding the final date of payments under the credit protection agreement.

- **Criterion 35 (Eligible credit protection agreement, counterparties, and collateral):** The EBA has not extended the scope of eligible credit protection to include unfunded protection provided by private sector protection sellers, such as insurers. This extended scope was an important request from some market participants in light of the fact that originators can address this counterparty risk by applying higher risk weights. The position remains as in the 2019 Discussion Paper, — providers of unfunded credit protection must be eligible for a 0% risk weight under the CRR, thus restricting the scope to government or international financial institutions. This result is not surprising given the EBA's primary concern with counterparty credit risk.

It remains to be seen if the various requirements set out in the STS criteria for synthetic securitisations err too much on the side of standardisation and simplicity to the detriment of flexibility, which would have allowed adaptation of transaction features to accommodate certain asset classes. Market adoption across asset classes will be the real test as to whether the regulatory exercise had struck the right balance.

Can differentiated capital treatment for senior tranches become too much of a good thing?

At the time of the 2019 Discussion Paper, the EBA treaded softly with respect to the introduction of more risk-sensitive regulatory treatment for the STS synthetic product, even though EBA knew this was an important point for market participants. A footnote to the "EBA Recommendations" section indicated that, depending on the conclusions following the public consultation, the EBA may consider introducing an additional recommendation on possible differentiated capital treatment. After market participants submitted their responses to the consultation, they have been waiting with bated breath for the next stage of the process.

The EBA Final Report makes true on its promise in the footnote by urging the EC to consider the advantages and disadvantages of such differentiated capital treatment and provides the EC with the tools necessary for its deliberations. However, as noted above, the EBA Final Report stops short of making an outright recommendation, thus leaving the final decision to the Commission. If a favourable decision is made, the report sets out what such differentiated regulatory treatment should consist of and the conditions to which it should be subject. Finally, in the spirit of giving to the EC the benefit of the full picture, the EBA tempers its recommendations by highlighting possible concerns.

The EBA first presents the more sensitive regulatory treatment as a natural implication of having created a simpler, more standardised, and more transparent product as well as the result of evidence-based good historical performance of the synthetic securitisation, which outpaces the performance of traditional securitisations. The EBA then recommends that, if introduced, such differentiated regulatory treatment should be limited and targeted in scope. The report clarifies that this means the regulatory treatment should not be applicable to all tranches of a synthetic securitisations or to both originating and investing institutions. It should only apply to the senior tranches retained by the originating bank.

According to the Final Report, the regulatory treatment of such senior retained tranches should be an adjustment of the prudential floor for the senior tranche retained by the credit institutions to a 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.

The differentiated regulatory treatment should also be subject to the following conditions:

- The securitisation meets the requirements on STS and the criteria specific to synthetic securitisation, as specified in the EBA Final Report.
- The securitisation meets the criteria under Article 243(2) of the amended CRR, as for traditional STS securitisation.
- The securitisation is a balance-sheet synthetic securitisation.

While the undertone is a subtle vote of confidence for synthetic transactions in light of their historical performance (zero defaults for senior tranches of synthetic securitisation), recognition of potential benefits, and desire to align with the traditional STS framework to stimulate market growth, the EBA highlights potential concerns:

- Differentiated capital treatment would be a departure from the Basel standards (but not the first one).

- So far the regulators and market have little experience with the STS framework for traditional securitisation.
- The performance data, although good, may not be representative and its time horizon may be limited, as the sample transactions are relatively recent and do not cover the full economic cycle.
- There is a concern that synthetic STS transactions with favourable capital treatment do not become a victim of their own success.

On this last point, EBA cautions against too much of a good thing. It considers that STS synthetic securitisations should not be overused and thus provide an incentive for banks to stop issuing capital instruments and implement large-scale substitution of regulatory capital through risk mitigation strategies (risk weighted asset reductions) resulting in increased leverage for banks. In other words, STS synthetic securitisations should not be the primary tool banks use for capital and risk management nor should it provide a disincentive from restructuring banks' business model but should be used instead as a complementary tool in the greater toolbox banks have available to them. It is a delicate balancing exercise. In addition to proper governance, the solution that the EBA recommends is regular monitoring. The introduction of any potential legislative solution enabling differentiated regulatory treatment should be accompanied by a mandate to the EBA to monitor the functioning of the STS synthetic market.

The EC will now take over deciding whether the timing is right for the introduction of a differentiated capital treatment for STS balance sheet synthetic securitisation, which will be an interesting exercise in the current context.

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Endnotes

1 Report on STS Framework for Synthetic Securitisation under Article 45 of Regulation (EU) 2017/2402 dated 6 May 2020, *available a*t https://eba.europa.eu/eba-proposes-framework-sts-synthetic-securitisation

2 The EBA Report on Synthetic Securitisation available at https://eba.europa.eu/sites/default/documents/files/documents/10180/983359/03ed077f-cdf9-4f6c-901b-fb7fda0e44a3/EBA-Op-2015-26%20EBA%20report%20on%20synthetic%20securitisation.pdf?retry=1

3 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 ***available at*** https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32013R0575

4 Regulation (EU) 2017/2402 of the European Parliament and of the Council dated 17 December 2017, ***available at*** https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2402&from=FR

5 Regulation (EU) 2017/2401 of the European Parliament and of the Council of 12 December 2017 amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms, *available a*t https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R2401&from=EN

6 Discussion Paper – Draft Report on STS Framework for Synthetic Securitisation Under Article 45 of Regulation (EU) 2017/2402, published on 24 September 2019 and *available at* https://eba.europa.eu/sites/default/documents/files/documents/10180/2963923/67358bc9-921d-49ec-86b6-144e90fa97b3/EBA%20Discussion%20Paper%20on%20STS%20syntehtic%20securitisation.pdf?retry=1