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IS SYNTHETIC SECURITISATION ABOUT TO BE BROUGHT IN FROM THE COLD?

Securitisations of the (previously) hopeless type

In response to what they divined to be the role of securitisation in causing and deepening the global financial crisis (**GFC**) a dozen years ago, in common with their counterparts elsewhere, European regulators imposed penalties and restrictions for originators of and investors in asset-backed securities (**ABS**). The central pillar of this new oversight was Regulation (EU) 2017/2402 (the **Securitisation Regulation**). Very broadly, the Securitisation Regulation imposes heavy regulatory capital charges on all EEA regulated investors in ABS, from banks to hedge funds, unless the securities concerned are the product of an elevated class of simple, transparent and standardised, or **STS**, securitisation. Remarkably, synthetic securitisations, where the originator of assets such as mortgage loans uses financial derivatives or similar arrangements to transfer the risks and returns of those assets to a third party, were considered so inherently complex, opaque and nonstandard, that they were expressly excluded by the Securitisation Regulation from the STS regime:

For further information on any of the issues discussed in this article please contact:

Richard Ambery
DD: +353 (0)1 674 1003
Richard.Ambery@dilloneustace.ie

Conor Keaveny
DD: +353 (0)1 673 1741
Conor.Keaveny@dilloneustace.ie

Securitisation Regulation Recital 24

In securitisations which are not true-sale, the underlying exposures are not transferred to an issuer entity which is a SSPE, but rather the credit risk related to the underlying exposures is transferred by means of a derivative contract or guarantees. This introduces an additional counterparty credit risk and potential complexity related in particular to the content of the derivative contract. For those reasons, the STS criteria should not allow synthetic securitisation.

By contrast, detailed rules were developed for traditional, so-called "true-sale" securitisations where there is an outright transfer (in law or equity) of the securitised assets and not just all or some of the credit risk associated with them. The STS regime was implemented through the EU securitisation framework (composed of the Securitisation Regulation and amendments to Regulation (EU) No 575/2013 on capital requirements (the CRR)), which entered into force on 1 January 2018 and became applicable on 1 January 2019. To date however, no European or global standards exist to identify a subset of synthetic securitisation products as simple, standard/comparable and transparent products.

Measures for rehabilitation

Unsurprisingly, blanket opposition to synthetic securitisation was not well received in sectors of the industry and jurisdictions such as Germany, where synthetic risk transfer off balance sheet of certain asset classes has become the preferred route. Indeed, some argued, synthetic transactions were the way to a more sophisticated future for the financing technique. Synthetic securitisations are better suited than traditional true-sale securitisations for many, particularly multi-jurisdictional transactions. Significantly, the European Banking Authority (the "**EBA**") has collated a body of evidence demonstrating (with some reservations) that synthetic securitisations of the type to which it is considered the STS should apply have performed better this century than true-sale ones across all asset classes.

Perhaps in response to this pressure, Article 45 of the Securitisation Regulation mandated the EBA to study and report on implementation of a specific regime for balance sheet STS synthetic securitisation. On 6 May 2020 we saw the final result of this when the EBA published its proposals: https://eba.europa.eu/eba-proposes-framework-sts-synthetic-securitisation (the **EBA Proposals**).

Removal from credit risk inventory

The Securitisation Regulation requires and the EBA readily accepts that proposals for a specific STS regime be limited to balance-sheet, as opposed to arbitrage synthetic securitisations. This is driven by the regulators' observation of very different loss experience for the two varieties: In the past, the EBA concludes, arbitrage synthetic transactions (including collateralised debt obligations, or **CDOs**) were structured to be complex and highly dependent on market values. Consequently, they

performed poorly in terms of historical defaults. Conversely in its opinion, synthetic transactions that have been used by institutions genuinely to transfer the credit risk from their lending activity off-balance sheet, i.e. **balance-sheet synthetics**, have performed relatively well.

Steps suggested for successful regulation

The fundamental principles of the EBA Proposals are:

(a) the establishment of a cross-sectoral STS framework, limited to balance-sheet securitisation; and

(b) that for any synthetic securitisation to be eligible as "STS", it should comply with the criteria on simplicity, standardisation and transparency, and additional criteria specific to synthetic securitisation referenced below.

The EBA Proposals contain a very helpful table that summarises similarities and differences between the EBA's suggestions for rules applicable to STS synthetic securitisations and the relative provisions for traditional non-ABCP transactions in existing legislation. Wherever possible, the EBA has attempted to reflect the form and principles of the Securitisation Regulation's Articles dealing with true-sale deals and we won't attempt to recreate the Authority's detailed thinking here. In essence however, the EBA Proposals keep the requirements for: (i) homogeneity of and absence of transferable assets in the portfolio; (ii) seasoning; (iii) referenced interest payments; (iv) a ban on resecuritisation and the exclusion of defaulted / disputed and self-certified loans; (v) originator expertise; and (vi) borrowers' creditworthiness. Likewise, the EBA Proposals mirror the Securitisation Regulation's rules on: (vii) servicer capability; (viii) resolution of conflicts between investors; (ix) historical data; (x) external verification; (xi) cash-flow modelling; (xii) environmental performance; (xiii) transparency; and (xiv) risk retention by the originator, original lender or sponsor.

To reflect the different form of synthetic transactions, the EBA Proposals adapt the Securitisation Regulation's rules on: (i) representations and warranties relating to assets; (ii) restriction of active portfolio management; (iii) underwriting standards; (iv) mitigation of interest rate and currency risk and (v) to reflect that not all synthetic transactions utilise a securitisation special purpose entity (**SSPE**). The true-sale STS rules relating to (vi) allocation of losses and amortisation of tranches; (vii) early amortisation; and (viii) transaction documentation are also specifically adapted.

Notably, the EBA Proposals put forward rules replacing the criterion for: (i) true sale with a definition of balance-sheet securitisation; and (ii) transaction documents to specify payment conditions with a requirement to maintain a register of credit protection reference assets. There are novel provisions dealing with: (iii) credit events; (iv) credit protection payments; (v) credit protection payments following close out / final settlement; (vi) credit protection premiums; (vii) credit event verification agents; (viii)

early termination events; (ix) excess spread; and (x) eligibility of credit protection agreements, counterparties and collateral.

Progress not perfection

In addition to adoption of the specific STS regime, the EBA has added a recommendation for the adoption of a differentiated regulatory capital treatment for STS framework-compliant synthetic securitisations. The differentiated treatment would only apply to the senior tranche of synthetic securitisations that are retained by the originating credit institutions. This is consistent with the EBA's commentary that post-GFC, originators of balance-sheet synthetic securitisations invariably syndicate only the junior and mezzanine tranches.

The EBA nevertheless sounds a note of caution that differentiated treatment could give rise to the risk of overuse of synthetic securitisation in substitution for raising regulatory capital, leading to an increase in bank leverage. The EBA therefore recommends that it be mandated to monitor STS framework for synthetic securitisations, the use of differentiated capital treatment and whether there is a corresponding increase in leverage through the banking system.

We now await the European Commission's consideration of the EBA Proposals with a view to proceeding to legislation.

Dillon Eustace
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Dublin
33 Sir John Rogerson's Quay, Dublin 2, Ireland. Tel: +353 1 667 0022 Fax: +353 1 667 0042.

Cayman Islands
Landmark Square, West Bay Road, PO Box 775, Grand Cayman KY1-9006, Cayman Islands. Tel: +1 345 949 0022 Fax: +1 345 945 0042.

New York
245 Park Avenue, 39th Floor, New York, NY 10167, U.S.A. Tel: +1 212 792 4166 Fax: +1 212 792 4167.

Tokyo
12th Floor, Yurakucho Itocia Building, 2-7-1 Yurakucho, Chiyoda-ku, Tokyo 100-0006, Japan. Tel: +813 6860 4885 Fax: +813 6860 4501.

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