EBA'S ADVICE ON SYNTHETIC SECURITISATION

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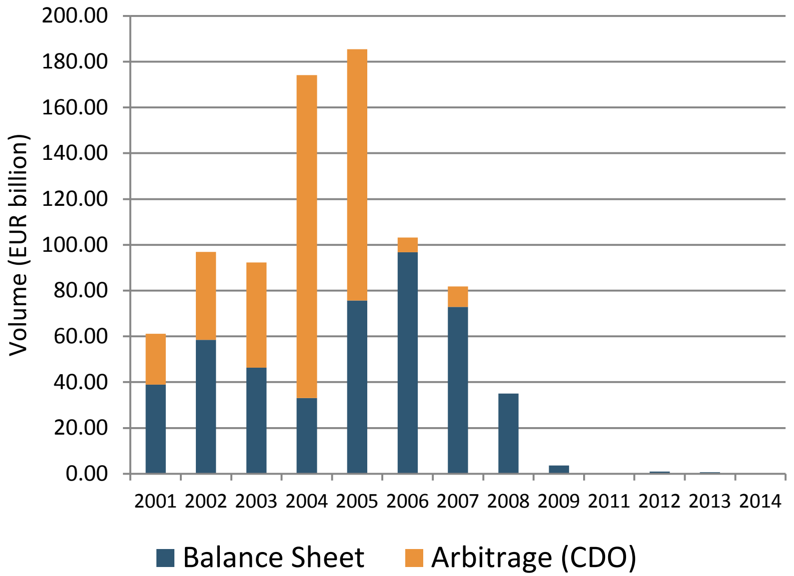
Content of the EBA Report on Synthetic Securitisation

- Published in December 2015, available at: https://www.eba.europa.eu/-/eba-issues-advice-on-synthetic-securitisation-for-smes

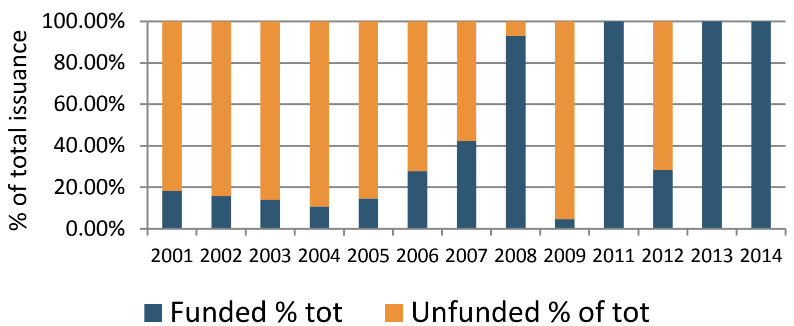
Market overview	• Issuance and performance of synthetics
Fundamentals of synthetic securitisation	• Definition of credit event; timing and determination of credit protection payments; moral hazard in credit protection contracts; use of synthetic excess spread; termination events; counterparty credit risk
Differentiated regulatory treatment of synthetic securitisation – based on Commission's securitisation proposal from Sept. 2015:	• **Scope of regulatory differentiation** • **Proposed technical amendments to COM's proposal** • **Criteria for 'qualifying' preferential treatment of some specific synthetic securitisations**

Market overview of Eur. synthetic securitisation

Issuance: balance sheet vs. arbitrage transactions



Issuance: funded vs. unfunded credit protection

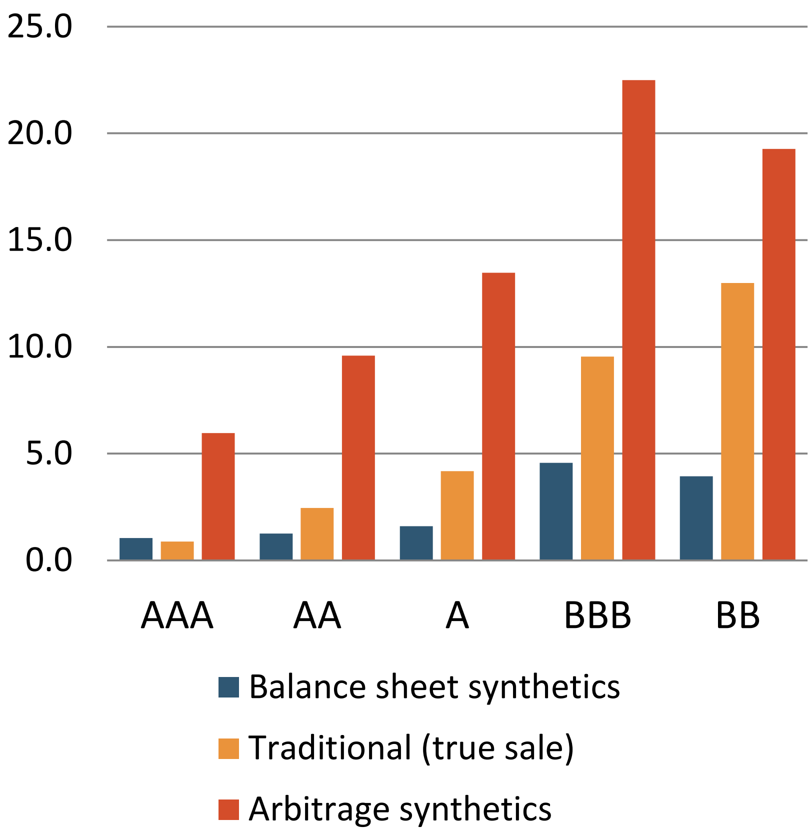


Main trends observed:

- Issuance peaked 2004/05: volume 180 bn EUR, majority of transactions of arbitrage type (CDOs)
- **Since 2006, gradual decrease in issuance: decrease of arbitrage transactions more pronounced than decrease of balance sheet transactions**
- Balance sheet transactions dominated by RMBS and balance sheet CDOs (within CDOs: CLOS and SME exposures were dominant); minor volumes of CMBS and ABS products
- Unfunded credit protection prevailing until 2008 – **since 2008 funded protection dominant**
- Issuance from 2008 mostly bilateral and not involving activity of rating agencies

Performance of synthetic securitisation

Lifetime default rate (%): balance sheet synthetic tranches, arbitrage synthetic tranches, traditional tranches, per rating grade
(source: S&P, as of 2014 and the EBA calculations)



Main observations from EBA analysis:

- **Arbitrage synthetics** performed **materially worse** than both (i) balance sheet transactions and (ii) traditional securitisation transactions
- The default performance of balance sheet synthetics is **comparable to that of traditional securitisation, for high rating grades**
- The default performance of balance sheet synthetics is **better than that of traditional securitisation, for lower rating grades**

EBA approach to qualifying treatment of synthetic securitisation: 3 pillars

<u>Substantial widening</u> of the scope of framework for preferential treatment of synthetic securitisation <u>premature</u> at this stage

<u>.. but general support to COM's proposal</u> (Art. 270 of sec. regulation of Sept. 2015)

<u>i.e. to restricted extension</u> of preferential 'qualifying' regulatory treatment (applicable to traditional 'qualifying' securitisation) to **some specific segments of synthetic securitisation,** limited to:

- **Balance-sheet securitisation**
- **SME exposures (at least 80%)**
- **Senior tranches only**
- **Retained by originators**
- **Guaranteed by 0% risk weight public entities**

More info on slide 6

<u>Technical amendments</u> to Commission's proposal:

- **Amended criteria for preferential treatment to reflect specificities of the synthetic securitisation**
- **Extension of the preferential treatment to transactions in which private investors provide credit protection in the form of cash**

More info on slide 7

General support to Commission's proposal

COM's proposal: preferential regulatory treatment (STS risk weight) is extended to <u>some specific synthetic transactions only</u>, complying with the following <u>conditions</u>:

Reasoning of the EBA's support for the overarching approach by the COM – as backed by the EBA analysis:

Balance sheet synthetic transactions	• Consistently better performance of balance sheet synthetics than arbitrage synthetics
SME portfolio (at least 80%)	• Wider evidence of zero defaults of highly rated synthetic tranches of SME exposures; data available for other asset classes less conclusive • Synthetic securitisation has typically been particularly active in corporate/SME class
Senior tranches only	• Not sufficient information and evidence on non-senior tranches in synthetic transactions
Retained by originator banks	• Prudential treatment of positions retained by originators is a key element shaping the supply side of balance sheet synthetics market • Prudential treatment of investor positions is less relevant factor, given the nature and composition of the investor base (mostly non-bank, sophisticated investors – hedge funds, asset managers, pension funds)
Credit risk transferred through a guarantee to 0% public weighted entities (CB, central government, multilateral development bank, int. organisation)	**EBA suggests technical amendment to this criterion – and to extend the framework to fully cash-funded credit protection provided by private investors**
The proposal does not extend to establish a fully-fledged STS framework for synthetics securitisation applicable to investors and across asset types	• Substantial widening of STS synthetic securitisation framework too premature at this stage

Technical amendments to Commission's proposal

Extension of framework (i.e. qualifying regulatory treatment) to fully cash-funded credit protection provided by private investors in the form of cash deposited with the originator

- Fully cash funded credit protection represents more than 90% of the issuance volumes surveyed by the EBA in relation to the period 2008-2014 – currently not eligible under COM's proposal
- Credit protection is immediately accessible, with no risk being incurred by the beneficiary
- CRR acknowledges this by imposing a 0% risk weight on cash received to fund credit protection

Amendments to the criteria determining eligibility for qualifying regulatory capital treatment

- Amendments/eliminations of some criteria to <u>fully reflect specificities of synthetic securitisation technique</u>
- Amendments/eliminations of some criteria to focus on <u>originator</u>
  - Disregard for criteria that exclusively reflect an objective of investor protection: e.g. criteria imposing enhanced transparency standards with regards to investors
- Addition of some <u>new criteria:</u>
  - Additional criterion 1 – ensuring that qualifying treatment only targets balance sheet transactions
  - Additional criterion 2 – criteria for eligible credit protection contracts and counterparties
  - Additional criterion 3 to 7 - ensuring that the credit protection contract is structured to adequately protect the position of the originator from a prudential perspective

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