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Discussion Paper

Draft Report on STS Framework for Synthetic Securitisation

Under Art. 45 of Regulation (EU) 2017/2402

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2. Responding to this Discussion Paper

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions stated in the boxes below (and in the Annex of this paper).

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the view expressed;
- describe any alternatives the EBA should consider; and
- provide where possible data for a cost and benefit analysis.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 25 November 2019. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

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Disclaimer

The views expressed in this discussion paper are preliminary and will not bind in any way the EBA in the future development of the draft Report. They are aimed at eliciting discussion and gathering the stakeholders' opinion at an early stage of the process.

3. Executive Summary

This Discussion Paper has been developed in response to mandate assigned to the EBA in the Securitisation Regulation (Regulation (EU) 2017/2402), which requires the EBA – in close cooperation with ESMA and EIOPA - to develop a report on the feasibility of a framework for simple, transparent and standardised (STS) synthetic securitisation, limited to balance sheet securitisation.

The Discussion Paper contains an extensive analysis of the synthetic securitisation market developments and trends in the EU, including data on the historical default and loss performance of the synthetic transactions both before and after the financial crisis (up until end 2018).

It examines the rationale of the STS synthetic product and assesses positive and negative implications of its possible introduction, both with and without differentiated regulatory treatment.

The Discussion Paper sets out a list of STS criteria for the synthetic securitisation. With the aim to ensure appropriate consistency, the STS criteria follow the structure of the STS criteria for traditional non-ABCP securitisation, introduced in the new EU securitisation framework in 2018 i.e. they include requirements on simplicity, standardisation and transparency, which are adapted to the specificities of the synthetic securitisation where appropriate. In addition, the criteria include a number of synthetic-specific requirements not found in the STS traditional framework, such as requirements mitigating counterparty credit risk inherently involved in the synthetic structures including requirements on eligible protection contracts, counterparties and collateral, addressing various structural features of the securitisation transaction and ensuring that the framework only targets balance sheet synthetic securitisation.

A separate chapter is dedicated to analysis of possible differentiated regulatory treatment of the STS synthetic securitisation. On the one hand, developments in the last few years have indicated a potential for the continuing growth of the synthetic sector, and have confirmed a technical feasibility of creation of prudentially sound STS synthetic securitisation product comparable to the STS traditional securitisation product. Also, the available performance data do not evidence worse performance of the synthetic securitisation instrument, compared to the traditional securitisation instrument.

Introduction of a limited and clearly defined differentiated regulatory treatment would thus match the historical performance of the synthetic securitisation, ensure level playing field with the STS traditional securitisation framework and help overcome constraints of current limited STS risk weight treatment of SME synthetic securitisations. On the other hand, the preferential regulatory treatment would not be compliant with international Basel standards. Also, limitations of the performance data on which the analysis is based, and a very limited experience with the STS traditional framework so far, should be duly taken into account.

Stakeholders are invited to comment on the possibility of introduction of the regulatory treatment, potential impact and level playing field and other considerations.

Next steps

Following the consultation on the Discussion Paper, the EBA will aim to publish a final report. Based on the EBA final report, the Commission shall submit a report to the European Parliament and the Council, together with a legislative proposal, if appropriate.

Abbreviations

ABS	Asset-backed security
AT1	Additional tier-1 capital
CDO	Collateralised debt obligation
CLO	Collateralised loan obligation
CMBS	Commercial mortgage-based security
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
EIB/EIF	European Investment Bank/European Investment Fund
EMEA	Europe, the Middle East and Africa region
IACPM	International Association of Credit Portfolio Managers
IFRS9	International Financial Reporting Standard 9
RWA	Risk-weighted asset
RMBS	Residential mortgage-based security
SEC-ERBA	Securitisation External Ratings Based Approach
SEC-IRBA	Securitisation Internal Ratings Based Approach
SEC-SA	Securitisation Standardised Approach
SME	Small and medium enterprise
SSM	Single Supervisory Mechanism
SRT	Significant Risk Transfer
STC	Simple, transparent and comparable framework (Basel)
STS	Simple, transparent and standardised framework (EU)
TLAC	Total loss absorbing capacity

4. Background and rationale

1. Article 45 of Regulation (EU) 2017/2402 (hereafter “Securitisation Regulation”) requires the EBA – in close cooperation with ESMA and EIOPA - to publish a report on the feasibility of a specific framework for simple, transparent and standardised synthetic securitisation, limited to balance-sheet synthetic securitisation. In line with recital 24 of the Securitisation Regulation this discussion paper also determines the respective STS criteria. Based on the EBA report, the Commission will assess whether to adopt a legislative proposal.

Figure 1: Mandate for the EBA report on STS synthetic securitisation in the Securitisation Regulation (Regulation (EU) 2017/2402)

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.

The progress made by the EBA in its report of December 2015, identifying a possible set of STS criteria for synthetic securitisation and defining ‘balance-sheet synthetic securitisation’ and ‘arbitrage synthetic securitisation’, should be acknowledged. Once the EBA has clearly determined a set of STS criteria specifically applicable to balance-sheet synthetic securitisations, and with a view to promoting the financing of the real economy and in particular of SMEs, which benefit the most from such securitisations, the Commission should draft a report and, if appropriate, adopt a legislative proposal in order to extend the STS framework to such securitisations. However, no such extension should be proposed by the Commission in respect of arbitrage synthetic securitisations.

Article 45:

1. By 2 July 2019, the EBA, in close cooperation with ESMA and EIOPA, shall publish a report on the feasibility of a specific framework for simple, transparent and standardised synthetic securitisation, limited to balance-sheet synthetic securitisation.
2. By 2 January 2020, the Commission shall, on the basis of the EBA report referred to in paragraph 1, submit a report to the European Parliament and the Council on the creation of a specific framework for simple, transparent and standardised synthetic securitisation, limited to balance-sheet synthetic securitisation, together with a legislative proposal, if appropriate.

2. The mandate for development of the STS framework for synthetic securitisation has a wider background and builds on the previous discussions and regulatory work on the topic.
3. First, Article 270 of Regulation (EU) 575/2013 on Capital Requirements¹ already allows for the preferential regulatory treatment of synthetic securitisation on a limited basis (i.e. of senior tranches of SME portfolios retained by originator credit institutions, provided that the significant credit risk has been transferred to either supranational entities (central banks, central government, multilateral development banks or international organizations) that are 0% risk weighted through unfunded guarantees, or to private investors through fully-collateralised

¹ 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

guarantees). These types of synthetic securitisations can benefit from lower risk weights which are currently assigned to STS traditional securitisation.

4. Second, this assessment builds on the **EBA Report on Synthetic Securitisation published in December 2015**². The EBA Report contains analysis and market practice assessment of the synthetic securitisation market. In the report, the EBA has proposed to extend the STS framework to fully-cash funded credit protection provided by private investors (at the time of publication of the EBA report, only credit protection provided by supranational entities has been eligible for STS treatment, under the Commission’s proposal on the amendments to the CRR). The EBA recommendations have been reflected in the final CRR (see the paragraph above).
5. In the EBA report, the EBA has also proposed to amend the criteria determining the eligibility for STS preferential treatment for balance sheet synthetic securitisation, and provided detailed proposals for such amendments. These included amendments to the criteria on simplicity, transparency and standardisation for traditional securitisation, and inclusion of new synthetic securitisation-specific criteria (largely aimed at ensuring that the credit protection contract is structured in a standardised fashion to adequately protect the position of the originator).
6. Third, the mandate follows the **EBA Discussion Paper on Significant Risk Transfer in Securitisation published in September 2017**³. The EBA Discussion Paper put forward for public discussions detailed proposals to strengthen the regulation and supervision framework of significant risk transfer (SRT) associated with the traditional and synthetic securitisation. In the discussion paper, the EBA proposed a number of recommendations for harmonisation of structural features widely present in synthetic and/or traditional securitisation, including on excess spread, pro-rata amortisation and others. The concept of SRT is extremely relevant for both traditional and synthetic securitisation, as achievement of the SRT is a precondition for originator to apply the securitisation framework (whether STS or non-STS) to retained securitisation exposures and to achieve capital relief. The SRT is particularly important for synthetic securitisation, as the transfer of risk, and associated capital relief, is one of key motivations to engage in this type of securitisation.
7. The recognition of synthetic securitisation has also been focus of **market initiatives**. For example, Prime Collateralised Securities (PCS) has launched its label in early 2017 that has been awarded to synthetic securitisations meeting defined criteria for a simple, transparent and standardised instrument⁴. The “PCS Risk Transfer Label” has been designed to provide a market reference standard for synthetic securitisations, similar to the “PCS True Sale Label” that has been introduced in 2012 and that is applied to traditional securitisations.

² EBA Report on Synthetic Securitisation: <https://eba.europa.eu/-/eba-issues-advice-on-synthetic-securitisation-for-smes>

³ EBA Discussion Paper on Significant Risk Transfer: <https://eba.europa.eu/regulation-and-policy/securitisation-and-covered-bonds/discussion-paper-on-the-significant-risk-transfer-in-securitisation>

⁴ See <http://pcsmarket.org/risk-transfer-label-outline/>. Up until now, the PCS Risk Transfer Label has been awarded to 7 securitisations: <http://pcsmarket.org/risk-transfer-transactions/>

Figure 2: STS treatment of synthetic securitisation in the CRR

Article 270: Senior positions in SME securitisations

An originator institution may calculate the risk-weighted exposure amounts in respect of a securitisation position in accordance with Articles 260, 262 or 264, as applicable, where the following conditions are met:

- (a) the securitisation meets the requirements for STS securitisation set out in Chapter 4 of Regulation (EU) 2017/2402 as applicable, other than Article 20(1) to (6) of that Regulation;
- (b) the position qualifies as the senior securitisation position;
- (c) the securitisation is backed by a pool of exposures to undertakings, provided that at least 70 % of those in terms of portfolio balance qualify as SMEs within the meaning of Article 501 at the time of issuance of the securitisation or in the case of revolving securitisations at the time an exposure is added to the securitisation;
- (d) the credit risk associated with the positions not retained by the originator institution is transferred through a guarantee or a counter-guarantee meeting the requirements for unfunded credit protection set out in Chapter 4 for the Standardised Approach to credit risk;
- (e) the third party to which the credit risk is transferred is one or more of the following:
 - (i) the central government or the central bank of a Member State, a multilateral development bank, an international organisation or a promotional entity, provided that the exposures to the guarantor or counter-guarantor qualify for a 0 % risk weight under Chapter 2;
 - (ii) an institutional investor as defined in point (12) of Article 2 of Regulation (EU) 2017/2402 provided that the guarantee or counter-guarantee is fully collateralised by cash on deposit with the originator institution.

5. Discussion

5.1 Introduction

Rationale for development of STS framework for traditional securitisation

8. One of the most important lessons of the 2007-2009 crisis was that defaults and losses associated with securitisation positions have varied substantially across different types of securitisations and regions. The crisis has also shown that the poor performance of certain products, irrespective of the pre-crisis rating level, was associated with recurring factors, including: (i) misalignment of interest between originators and investors resulting in loose underwriting standards on the underlying exposures; (ii) excessive leverage; (iii) maturity transformation; and (iv) complex structures. Complex transactions have been assessed by external rating agencies using erroneous modelling assumptions and have been placed with investors without adequate transparency standards.
9. In 2015, following an extensive analysis the EBA proposed that the regulatory approach to traditional securitisations should distinguish between the regulatory treatment of ‘qualifying’ securitisations and that of other securitisations, given a one-size-fits-all regulatory approach may result in an unduly conservative treatment of transactions that are simple, standard and transparent, as well as being collateralised by relatively less risky exposures.
10. The EBA therefore recommended that regulatory definition of the ‘qualifying’ securitisation should follow a ‘two-stage approach’⁵ whereby in order to qualify for differential treatment, a securitisation transaction should first meet a list of criteria ensuring simplicity, standardisation and transparency that aim to capture and mitigate the major drivers of risk of a securitisation that are not related to the underlying exposures (such as agency risk between various participants in the securitisation process, legal and governance risks, counterparty risks, servicing risks, liquidity risks, risks of operational nature), and hence facilitate the assessment of the risks by the investors. As a second step, the EBA proposed that the underlying exposures should meet criteria of minimum credit quality of the underlying exposures, to address modelling and credit risk related to the underlying exposures. Consequently, the securitisation compliant with the requirements set out under the two-stage approach should be subject to a differentiated regulatory capital treatment compared to other securitisations, and should aim at more appropriate levels of non-neutrality of capital charges.
11. The regulatory recognition has been so far principally focused on traditional securitisation and not on synthetic securitisation. Synthetic securitisation has been left outside the scope of the ‘STS’/‘STC’ reforms recognising simplicity, transparency and standardisation of the securitisation

⁵ The EBA recommended that the two-stage approach and the related STS criteria should distinguish term securitisations from short-term securitisations in the context of ABCP programmes.

i.e. it has been assigned the regulatory capital treatment of non-STC securitisation foreseen by the Basel 2014 revision of the securitisation framework (globally) and of non-STC securitisation set out in the amended CRR (in EU). At this stage, therefore, no European or global standards exist to identify a subset of synthetic securitisation products as simple, standard/comparable and transparent products.

12. With respect to traditional securitisation, the STS framework for traditional securitisation was proposed by the EBA in the EBA Report published in July 2015⁶, while it was subsequently adopted and implemented by both international and EU regulatory community. The Basel 'STC' framework for term securitisation was adopted in July 2016 and entered into force in January 2018, while the 'STC' framework for short term securitisation was adopted in May 2018 and entered into force immediately thereafter. In the EU, the 'STS' framework has been implemented through the EU Securitisation Framework (composed of the Securitisation Regulation and the amendments to the CRR) which entered into force on 1 January 2018 and became applicable on 1 January 2019.

Rationale for a limited focus on synthetic securitisation so far

13. There has been several reasons for the enhanced focus of the regulatory recognition on traditional securitisations. First, detailed data have been available on the historical credit performance of the traditional securitisation market which confirmed a good performance of the EU securitisation market in the pre-crisis period (e.g. according to EBA Report on qualifying securitisation, EMEA RMBS and ABS products displayed almost zero losses over the period 2000-2013). Second, the traditional securitisation has traditionally played an important role in the financial markets, as a channel for diversifying funding sources, distributing financial-sector risk and helping to free up originators' balance sheet for further lending on economy. The STS framework was a way of acknowledgment by the regulatory community of positive implications that a sound traditional securitisation can have for the financial stability and for the funding of the real economy.

14. In the same vein, there were several reasons for a so far conservative approach by the regulators to synthetic securitisation. One of core considerations was a lack of systematic and publicly available data on market developments, volume and historical performance of the synthetic securitisation and of different asset classes in Europe. This is because the synthetic deals in the post-crisis period have mostly been bilateral and therefore almost entirely private, with very little information available publicly.

15. The data available on synthetic securitisation at that time supported the fact that different types of synthetic securitisations performed differently, both with respect to structural types of synthetic securitisation as well as with respect to different asset classes. First, there was a clear evidence that arbitrage synthetics performed materially worse than balance-sheet securitisations. The arbitrage synthetic transactions have been structured in the past to be

⁶ EBA Report on Qualifying Securitisation, July 2015:
<https://eba.europa.eu/documents/10180/950548/EBA+report+on+qualifying+securitisation.pdf>

complex, highly dependent on market values, and have performed poorly in terms of historical defaults. On the other hand, synthetic transactions that have been genuinely used by institutions to transfer the credit risk of their lending activity off-balance sheet, i.e. balance sheet synthetics, have performed relatively well. Second, there was a wider evidence for zero defaults in relation to highly rated synthetic tranches of SME exposures, although information on other asset classes was less conclusive. Nevertheless, data available from rating agencies suggested that the default performance of balance sheet synthetics is comparable to that of traditional securitisation for high rating grade, and even better for lower rating grades.

16. In addition, the market of synthetic securitisation, to a much larger extent than the one of true sale securitisation, has traditionally been characterised by issuance of bespoke transactions, i.e. it has been largely non-standardised. In particular, the credit protection mechanism, which is the core of a synthetic securitisation transaction and constitutes the structural element of difference with respect to true sale transactions, has been implemented in accordance with a wide spectrum of practices and was perceived at the time to increase the structural complexity due to the additional counterparty credit risk of the protection seller.

17. The lack of systematic data at that time, analysis available at that time and, as a consequence, no sufficient evidence or information on whether it was possible to standardise the synthetic structure similarly as for traditional securitisations, did not support development of fully-fledged STS framework for synthetics across different asset types. Instead, regulatory recognition focused on limiting the scope of the qualifying treatment to senior positions retained by the originator banks and to SME exposures. At that stage it was however clear that arbitrage synthetics should be excluded from the STS framework, and any potential STS framework should be limited to balance-sheet synthetics.

Question 1: Do you have any comments on this introductory section of the Discussion Paper?

5.2 Market developments and trends

5.2.1 Data sources

18. The analysis in this section is based on the following data sources:

- a. data from market participants and rating agencies, in particular:
 - i. data on the **volume of balance sheet synthetic securitisation transactions, and investor base**, since 2008 to early 2019. The data have been collected in an exercise conducted by IACPM in the 1st quarter 2019. They include responses provided by 22 banks that are most active in the synthetic securitisation market in Europe and cover 244 balance sheet securitisation transactions.
 - ii. **with respect to the historical performance of synthetic securitisation**, data from two sources: (i) data on historical performance of balance sheet synthetics, gathered through data-gathering exercise coordinated by IACPM, and covering 70 transactions executed by 14 banks (the data cover period from 2008 to early 2019 i.e. are representative of the post-crisis period), (ii) data from S&P on historical performance of balance sheet synthetics, covering in total 5948 synthetic securitisation tranches of rated synthetic transactions in Europe (although the data also cover the period from 2008, substantial majority of tranches were rated pre-crisis, and these data are therefore mostly representative of the pre-crisis period).
- b. data from the reporting by competent authorities on synthetic transactions that achieved significant risk transfer (SRT) and hence need to be notified to the EBA in line with the EBA SRT Guidelines from 2015 to Q1 2019;
- c. information gathered through industry roundtable organised by EBA in March 2019 and other qualitative market analysis.

5.2.2 Market developments

Volume and size of the market

19. Before the financial crisis, European synthetic securitisation peaked in 2004-2005 with volumes above 180 billion EUR and a substantial majority of arbitrage transactions (mostly CDOs). Issuance almost halved in 2006 and then gradually dropped to zero, with arbitrage synthetic securitisations decreasing faster than balance sheet synthetic securitisations.

20. The 2008 financial crisis marked a crash of the securitisation market, after which, also due to stigma attached to the synthetic segment, the securitisation market has gradually emerged in particular in the traditional (and retained) form. With respect to synthetic securitisation,

following a few years of subdued issuance, the synthetic market has been recovering in the recent years, with both the number and volume of transactions steadily increasing. Based on the data collection conducted by IACPM, altogether 244 balance sheet synthetic securitisations have been issued since 2008 up until end 2018. In 2018, 49 transactions have been initiated with a total volume of 105 billion EUR.

21. Arbitrage transactions have disappeared from the European market, which is now formed almost exclusively by balance sheet transactions. In terms of volume, balance sheet synthetics in 2018 has overstepped the highest pre-crisis volumes (based on comparison of post-crisis volume data by IACPM and pre-crisis volume data by BofAML).

Figure 3: European synthetic securitisation issuance, pre-crisis: balance sheet vs. arbitrage transactions (in EUR billion, source: BofAML)

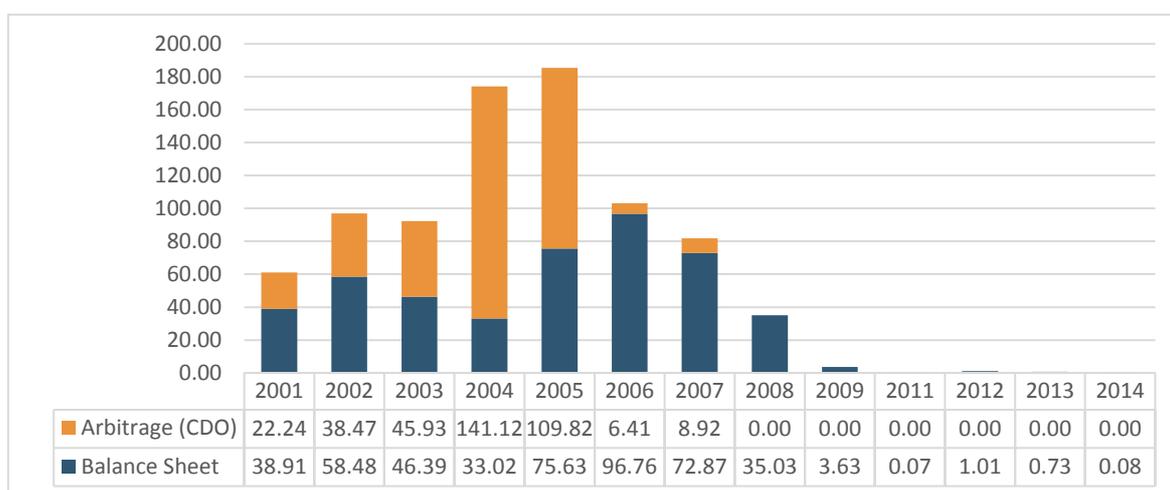
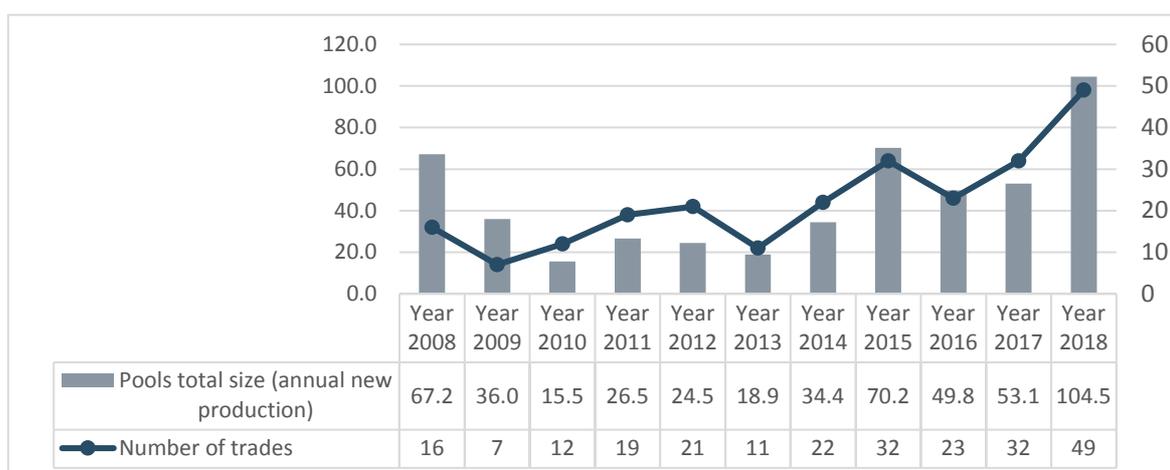


Figure 4: European balance sheet securitisation issuance, post crisis (size on the left axis in EUR billion, source: IACPM)

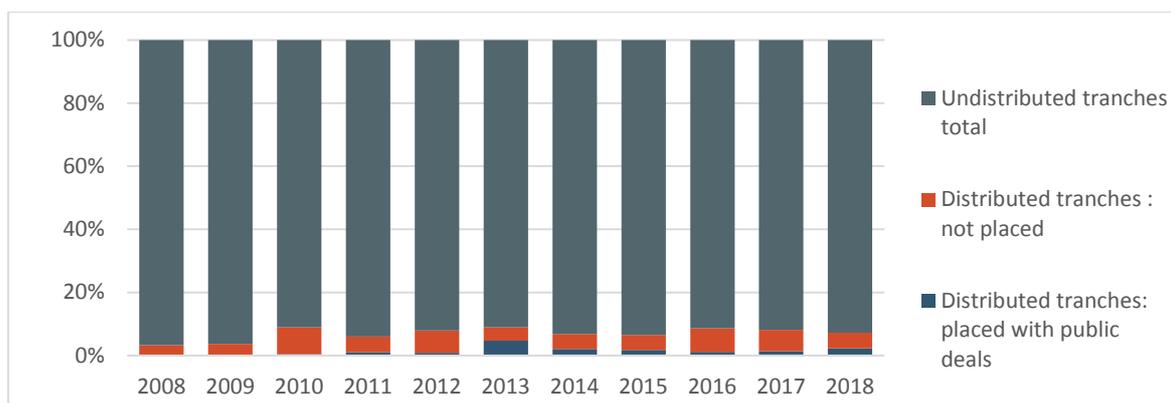


Private/public transactions

22. In contrast to the pre-crisis period where a substantial part of synthetic securitisation transactions were public and rated (e.g. the Promise and Provide programmes in Germany, the Bistro deals by JPMorgan), since the financial crisis the deals have mostly been executed

privately/bilaterally, without involvement of credit rating agencies. Based on the data from IACPM covering transactions from 2008-2018, 18.6% of distributed tranches of all the transactions were placed publicly, which only represents 1.55% of the total size of the transactions.

Figure 5: Placed vs not placed part of the tranches of all transactions per year (source: IACPM)

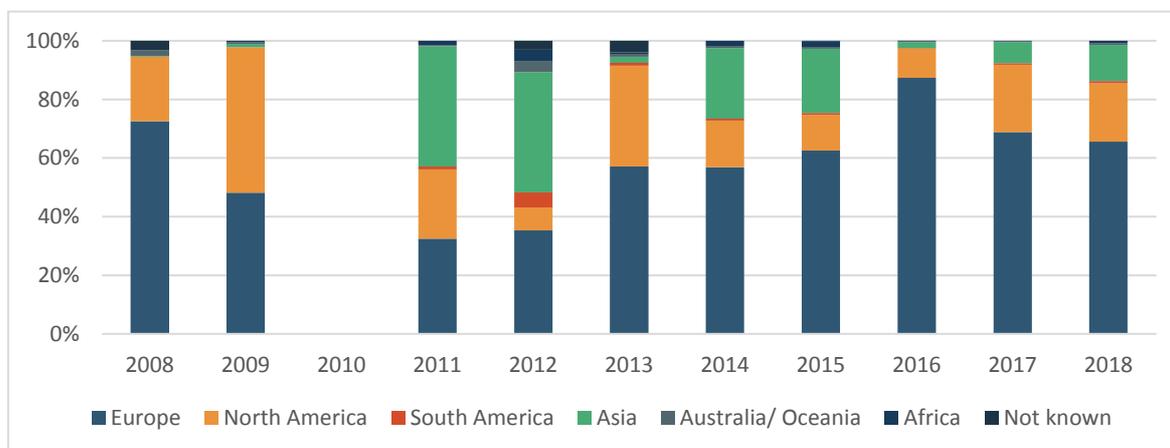


Year/Distributed tranches (in EUR million)	Undistributed tranches Total size	Distributed tranches total size (not placed)	Distributed tranches (placed with public deals)	Distributed tranches placed with public deals (% of distributed tranches)	Distributed tranches placed with public deals (% of total size of the transactions)
Year 2008	64925	2229	0	0.0%	0.00%
Year 2009	34632	1340	0	0.0%	0.00%
Year 2010	14148	1314	78	5.6%	0.55%
Year 2011	24923	1328	276	17.2%	1.11%
Year 2012	22562	1732	221	11.3%	0.98%
Year 2013	17228	802	894	52.7%	5.19%
Year 2014	32031	1639	702	30.0%	2.19%
Year 2015	65601	3382	1226	26.6%	1.87%
Year 2016	45442	3727	5868	13.6%	1.29%
Year 2017	48738	3647	700	16.1%	1.44%
Year 2018	96975	5137	2417	32.0%	2.49%
Max value:				52.7%	5.19%
Average:				18.6%	1.55%

Geographical distribution of exposures

23. In terms of geographical breakdown, there is a clear tendency to form pools that mix exposures from different jurisdictions. While the majority of exposures of all 244 synthetic transactions issued in Europe since 2008 are located in Europe, there is a substantial share of exposures from outside Europe.

Figure 6: Weighted average geographical breakdown (% of pools total size, covering 244 synthetic transactions, source: IACPM)⁷



24. A separate analysis of individual synthetic transactions shows that the majority of the transactions (42 out of 70, i.e. 60%) contain multi-jurisdictional exposures, while most of them contain exposures outside Europe. Less than the majority of synthetic transactions (40%) contain exposures located in one jurisdiction only.

25. This confirms a specific nature of synthetic securitisation which is inherently easier to execute on multi-jurisdictional portfolios and represents a comparative advantage vis-à-vis traditional securitisation (including due to legal complexities associated with the true sale/transfer of underlying exposures subject to different legal regimes, client confidentiality issues present in traditional securitisations and other factors).

Placed risk

26. Synthetic transactions are nowadays limited to placing junior and mezzanine risks. Originators tend to transfer the junior (mezzanine and/or first loss) element of the portfolio's credit risk, which on average represents 13% of the total volume of transaction, and retain the senior tranche of the same portfolio, which is typically, and by far, the largest of the tranches (around 87% of the total volume of transaction)⁸.

27. This is in contrast to the pre-crisis period where originators typically placed the super senior tranches of synthetic transactions (and hence the largest tranches of the transaction in terms of volumes) with monoline insurers and/or highly rated investor institutions, to, inter alia, smooth the expected decrease in regulatory capital in transition between Basel 1 and Basel 2 (CRD entered into force in January 2007 and introduced internal model approaches to capital requirements).

28. Following the crisis, originators have changed their involvement in the synthetic securitisation market to only place, to the extent possible, mezzanine/first loss tranches with investors. This is

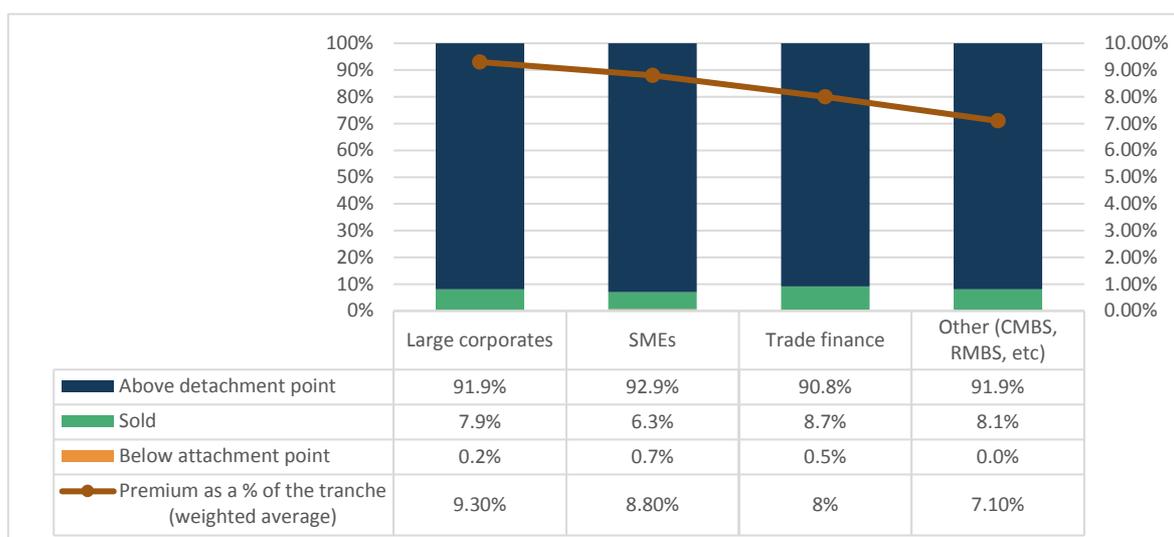
⁷ Data for 2010 are not available.

⁸ Based on average of 47 transactions, IACPM

a reflection of various factors such as materially different funding, macro-economic and regulatory environment, as well as changes in the investor base (withdrawal of monoline insurers and other relevant parties from the market). It has been observed that this reflects the change in motivation to engage in synthetics: regulatory capital management is no longer the sole motivation, other credit risk and balance sheet management considerations are becoming important determinants under the current macro-economic environment and changes to the regulatory framework, allowing banks to hedge the tail risk and free up credit lines that may be used for further lending.

29. Given that under the current rules of the EU securitisation framework which will start to apply once the grandfathering period is over (from 2020), and which increase (and almost double) the capital charges for senior tranches, it is not clear whether this trend (i.e. placing first loss/mezzanine risk) will persist or will change further in a way that the originators may consider placing senior risk in addition to mezzanine and junior risk (this expectation is under alternative of no capital benefits for the senior tranche).

Figure 7: Attachment and detachment point of the risk sold of balance sheet securitisation transactions in 2018 (source: IACMP)



30. Based on qualitative feedback from the stakeholders, other trends as a consequence of the revision of the CRR securitisation framework may include: securitisation of different asset classes such as specialised lending exposures, changes in the structural features of the synthetic transactions as a consequence of bilateral, bespoke and unrated nature of the transactions, and with the aim of achieving significant risk transfer, potential changes in attachment and detachment points creating thicker and higher number of mezzanine tranches in order to transfer sufficient risk to third parties.

Originators (protection buyers)

31. Originators of synthetic securitisation are mostly credit institutions, in particular large/systemically important banks using Internal Rating-Based models for calculating capital requirements for credit risk. Banks applying Standardised Approaches to credit risk are rarely originators of synthetic securitisations. This is mainly due to reluctance to enter a largely unstandardised/bilateral market without prior experience, as well as challenges related to accessing portfolio data, and relating to reporting and transaction costs⁹. However, recently some standardised banks have entered synthetic transactions supported by EIB/EIF in the context of the EIB/EIF's European SMEs initiatives.

32. The analysis reveals a number of factors that contribute to the growth of the synthetic market on the originator side. For originators, having another credit risk management tool and being able to release capital have traditionally been the central benefits of a balance sheet synthetic securitisation. Synthetic securitisation as a credit risk and balance sheet management tool for banks remains relevant in the current operating environment also due to recent regulatory developments, which enhance requirements for banks' balance sheet management. These include in particular the following regulatory developments: (i) the Basel III framework approved in December 2017 and applicable from 2022, including strengthened capital requirements, revisions to the leverage ratio, and introduction of the output floor; (ii) requirements under accounting reform IFRS9; (iii) exposure management requirements; (iv) changes in the context of the fundamental review of the trading book. These changes may lead to, on the one hand, increased demand by banks for equity, and equity-linked or TLAC instruments, and on the other hand, increased focus by banks on better balance sheet management through the available credit management tools.

Investors (protection sellers)

33. A substantial majority of investors in synthetic securitisation are non-bank private entities, which are usually highly specialised in credit investing and experienced in portfolio due diligence. The main motivation for investors to invest in synthetic securitisation is search for higher yield and enhanced diversification of their investments.

34. With respect to the private investors, they mostly include hedge funds (39.6% in terms of volume of distributed tranches over 2008-2019), pension funds (30.6%) and asset managers (19.7%). Insurance companies only form a minority of the investor base (less than 1%). 90% of the credit protection provided by the private investors is funded credit protection. Credit institutions enter the current market of synthetic securitisation as originators and not as investors.

35. With respect to public investors, 4.5% of them are 0%-risk-weighted multilateral development banks. This includes EIB/EIF, which continue to be an important investor dominating the SME

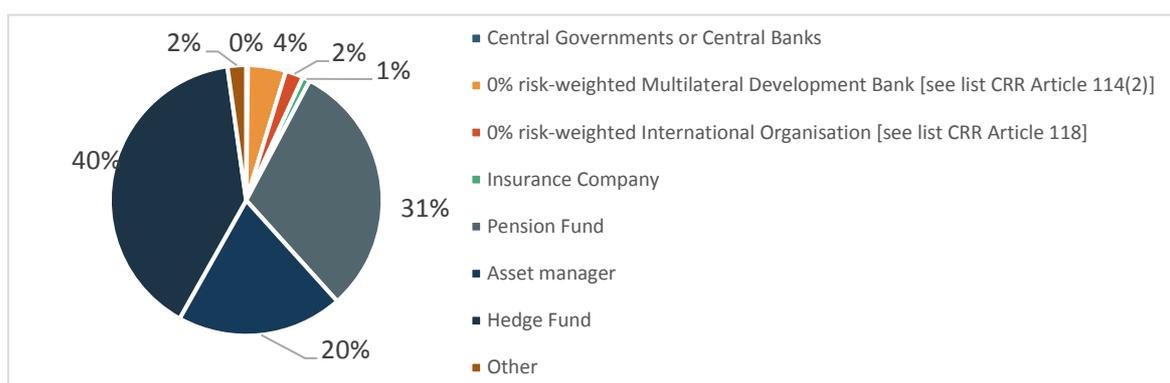
⁹ Standardised banks need external ratings on retained senior tranches (or alternatively the need to place or guarantee such tranches), which adds to transaction costs.

synthetic market. Under the European Commission's investment plan for Europe (the 'Juncker Plan'), EIB/EIF have played an important role in providing credit protection to banks with the mandate to promote the lending to SME and reuse the freed-up capital into new SME lending.

36. In the last two years, there has been an increase in share of public investors (in particular 0% risk-weighted multilateral development banks) and hedge funds and decrease in share of pension funds. Other recent trends from anecdotal evidence suggest diversification of the investor base (with some trades involving family offices and delegated funds), as well as growing investor base. The trends indicate potential for further expansion of the investor base, also due to involvement of new asset classes (e.g. infrastructure loans, commercial real estate loans, globally or regionally diversified corporate portfolios) which may attract new investors specialising and prioritising such assets.

Figure 8: Investors, in terms of % volume of distributed tranches over 2008-2019 (source: IACPM)

Type of investor	2008-2017	2008-2019
Public investor: out of which	1.1%	6.8%
A. Central Governments or Central Banks	0.2%	0.2%
B. 0% risk-weighted Multilateral Development Bank [see list CRR Article 114(2)]	0.6%	4.5%
C. 0% risk-weighted International Organisation [see list CRR Article 118]	0.3%	2.1%
Private investor (and no guarantee from A or B): out of which	98.9%	92.9%
D. Insurance Company	0.2%	0.9%
E. Pension Fund	40.1%	30.6%
F. Asset manager	15.1%	19.7%
G. Hedge Fund	33.3%	39.6%
H. Other	2.8%	2.2%
Part of private investor which is funded	89.7%	90.1%



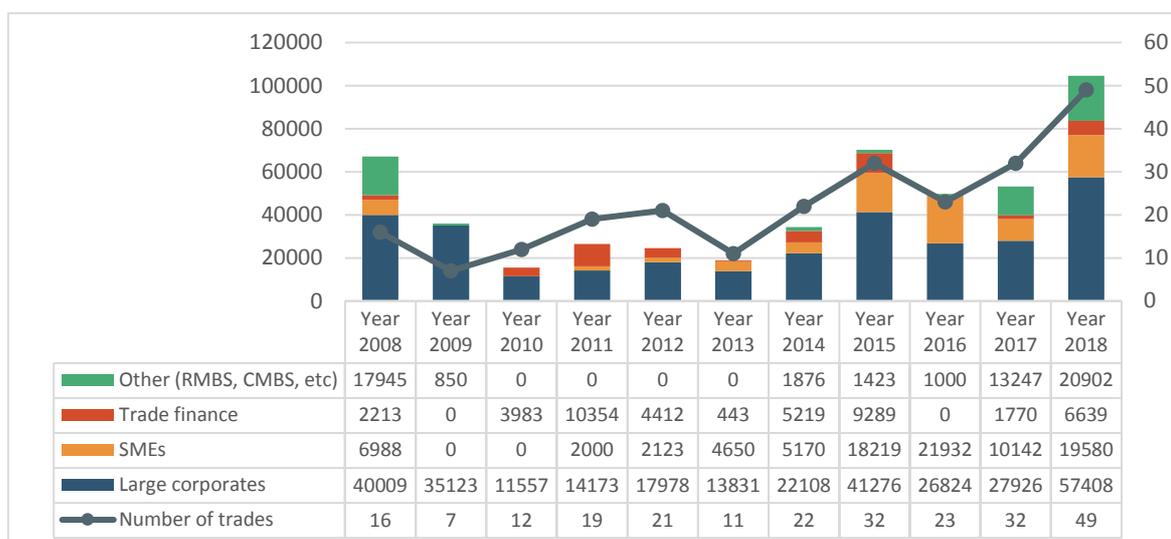
Asset classes

37. The predominant asset classes continue to be large corporates and SMEs, followed by trade finance. This indicates that balance sheet synthetic securitisation is used to larger extent for the transfer of corporate credit risk from banks to markets, than the traditional securitisation. SME securitisation has been spurred also due to the mandate of EIB/EIF. In general, the securitised

assets are primarily RWA-intensive assets that allow better to achieve objectives of risk transfer and capital relief.

38. There has been a trend in diversification of the asset classes, which now include also specialised lending (including infrastructure loans), commercial real estate, residential real estate, trade receivables, auto loans, micro loans and farming loans. Weighted average life of the transactions is on average 35 months.
39. Securitised assets also tend to be assets that are core to the bank business, which reflects, on the one side, originators' interest in balance sheet management and also investors' demands for better alignments of interest. Also for this reason, it is not common to see synthetic securitisation from stressed or distressed institutions, or synthetic securitisations of non-performing loans portfolio (which are mostly securitised under traditional securitisation structure through true sale). None of the securitised transactions reported by IACPM contained non-performing portfolios.
40. Retail exposures, such as RMBS and consumer loans, are less common in synthetic securitisation. They are securitised mostly for funding, and not credit risk management due to various reasons, including due to the fact they have relatively lower risk weights. They also have internal ratings and are more prone to be subject to concentration limits of the banks and are therefore more appropriate for traditional securitisation.
41. Going forward, we expect changes in the asset classes in light of the regulatory capital requirements (including the output floor), which will decrease the credit risk transfer benefits for SME loans and increase the capital benefits for specialised lending and consumer/retail exposures. It is also expected there may be an increase in multi-jurisdictional and/or multi asset class portfolio trades.

Figure 9: Asset classes, volume (in EUR million), number of trades (source: IACPM)



Changed characteristics compared to pre-crisis period

42. As indicated in the analysis above, the development of the synthetic securitisation market in the EU can be divided in two episodes: before and after the financial crisis, with a number of significant differences between these two periods. The summary of the main changes is provided below:

- a. While the majority of the transactions in the pre-crisis period were arbitrage transactions, after the crisis the European market is formed almost exclusively by balance sheet transactions.
- b. In contrast to the pre-crisis period where a substantial part of synthetic securitisation transactions were public and rated, since the financial crisis the deals have mostly been executed privately/bilaterally, without involvement of the credit rating agencies.
- c. With regard to originator's involvement, 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 or mezzanine/first loss (smaller) tranches.
- d. 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.

Figure 10: Summary comparison of synthetic market pre- and post-crisis (EBA, Integer Advisors)

	Synthetic market pre-crisis	Synthetic market post-crisis
Market	Public	Private or bilateral
Type of securitisation	Arbitrage and balance sheet	Almost exclusively balance sheet
Private/public	Mostly public and rated	Mostly private and bilateral
Assets	Mostly corporates	Mostly corporates, diversification and addition of new asset classes
Originators	Larger to mid-tier banks, standardised banks moving to IRB	Large banks, mostly SIFIs
Investors	Broad, ABS mainly	Narrow, alternative mainly
Government programs	National (eg KfW)	Europe-wide via supras (eg EIB/EIF)
Structure	Full synthetic structure (senior + junior)	Mezz/junior only
Credit protection mechanism	Unfunded	Funded, and unfunded for public

Additional data from SRT notifications

43. According to the EBA Guidelines on significant risk transfer (SRT) for securitisation transactions¹⁰, competent authorities have to report to the EBA each securitisation transaction on which the EBA Guidelines require them to conduct a comprehensive assessment. The competent authorities report to the EBA on an annual basis. To be noted that the data from the notifications represent a sample and are not fully representative of the market. It is expected that the data do not cover, for example, all repeated transactions, transactions with exposures outside the EU, transactions pending approval or other types of transactions.

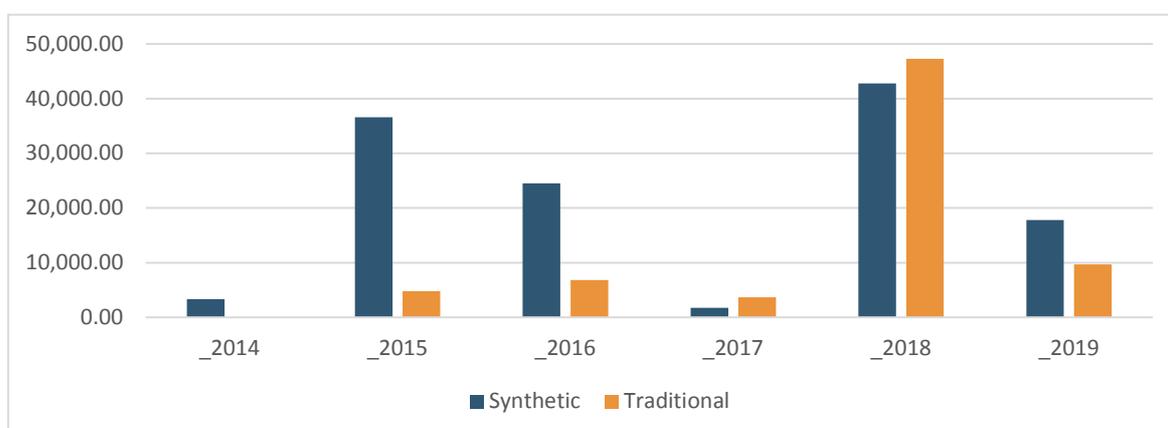
44. Since the entry into force of the Guidelines in July 2014, altogether 142 SRT transactions have been notified by five competent authorities (ECB, GR, IT, SE, UK), with a total notional value of 199 bn EUR. In case of SSM, the notifications related to transactions of significant institutions covering various jurisdictions.

Figure 11: Data on the SRT transactions notified to EBA (from July 2014)

	2014	2015	2016	2017	2018	Q1 2019	Total
Number of transactions	3	20	25	6	60	28	142
Out of which synthetic	3	17	17	3	35	20	95
Out of which traditional	0	3	8	3	25	8	47
Total notional value (mln EUR)	3,328.50	41,363.60	31,326.80	5,400.80	90,028.30	27,446.30	198,894.30
Out of which synthetic (mln EUR)	3,328.50	36,579.10	24,485.00	1736.7	42,765.10	17,791.10	126,685.50
Out of which traditional (mln EUR)		4,784.50	6,841.90	3664	47,263.20	9655.3	72,208.80

45. Synthetic securitisations represent a significant majority of the SRT transactions: 95 out of 142 transactions were synthetic, with the total notional value 126 bn EUR (63.7 % of the total notional value of all reported transactions).

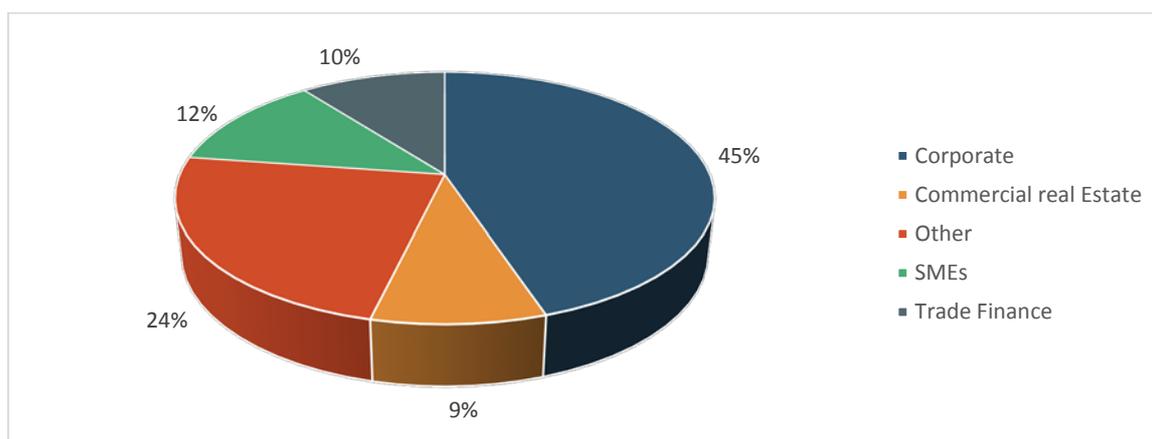
Figure 12: Notional amount of synthetic and traditional SRT transactions, per year, from 2014 to Q1 2019 (in million EUR)



¹⁰ EBA Guidelines on significant risk transfer for securitisation transactions, July 2014: <https://eba.europa.eu/regulation-and-policy/securitisation-and-covered-bonds/draft-guidelines-on-significant-risk-transfer-srt-for-securitisation-transactions>

46. With respect to asset types in the synthetic securitisations, corporate loans were the most widely used type of collateral in synthetic securitisation: 31 transactions, representing 45% of the notional value, were collateralised by corporate loans. The other common types of collateral were, in terms of number of transactions, commercial real estate, SME loans, trade finance, and other types of assets (such as consumer loans in 10 transactions, residential mortgages, social housing, leasing receivables, and mixed asset types).

Figure 13: Type of collateral in the SRT synthetic transactions reported from July 2014



Type of collateral	Notional amount	% of total notional amount	Number of transactions
Corporate	56,832	44.9%	31
Commercial real Estate	11,105	8.8%	24
Other ¹¹	29,981	23.6%	21
SMEs	15,603	12.3%	15
Trade Finance	13,164	10.4%	4
All	126,686	100.0%	95

Question 2: Do you agree with the analysis on the market developments? Please provide any additional relevant information to complement the analysis.

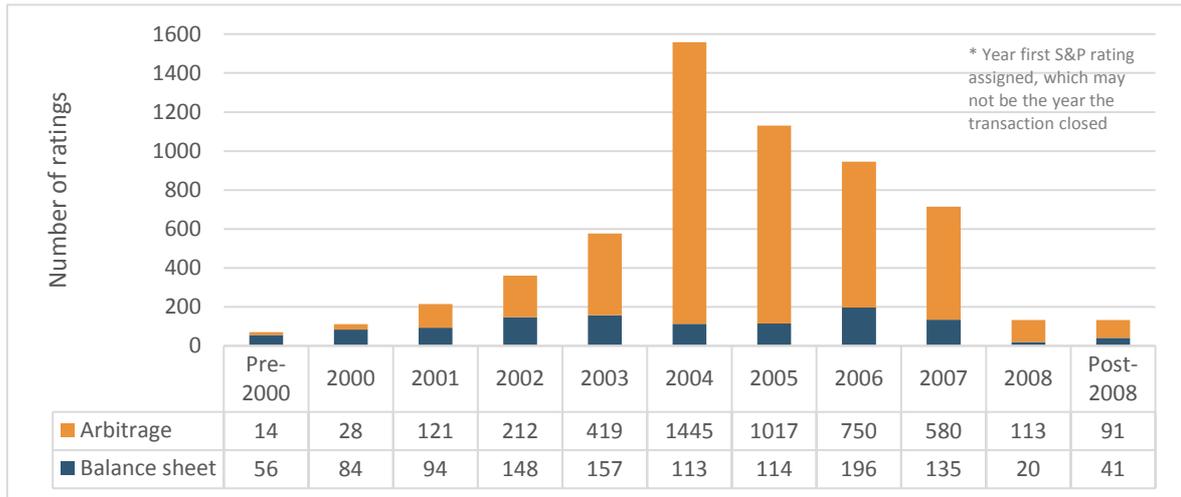
¹¹ Other include: residential mortgages (3), leasing receivables (1), consumer loans (10), social housing (1) mixed types of assets and other (6).

5.2.3 Historical performance

47. The analysis below is based on data sources referred to in Section 5.2.1.

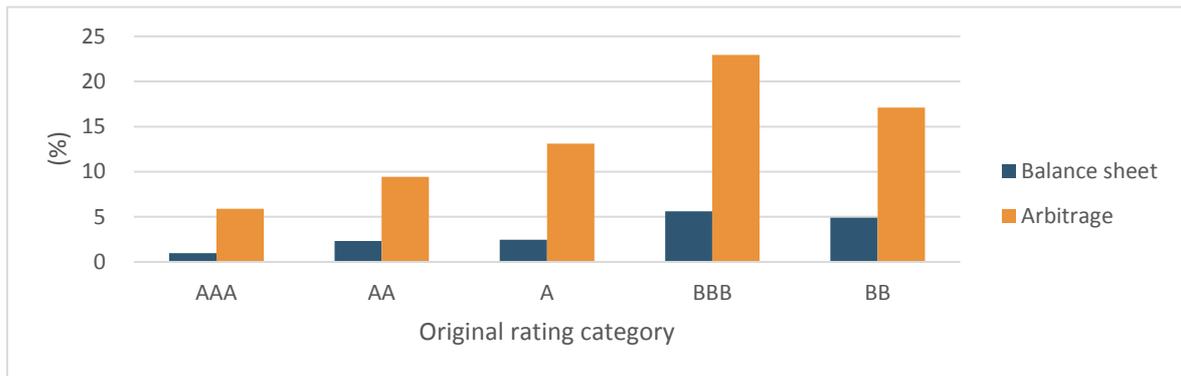
48. The S&P data indicate that in pre-crisis period, 80.1% in terms of number of ratings were arbitrage securitisations.

Figure 14: Arbitrage versus synthetic securitisations, number of ratings (source: S&P)



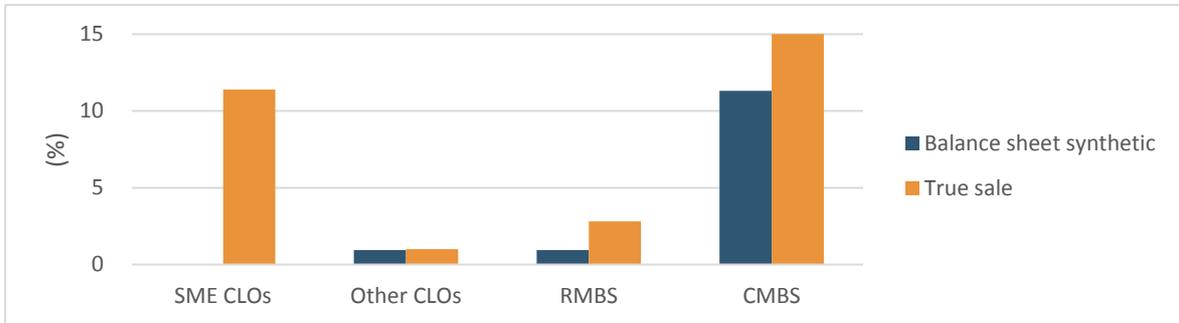
49. The arbitrage synthetics have performed materially worse than the balance sheet transactions.

Figure 15: Lifetime Default Rate for synthetic tranches (as of end 2018, source: S&P)



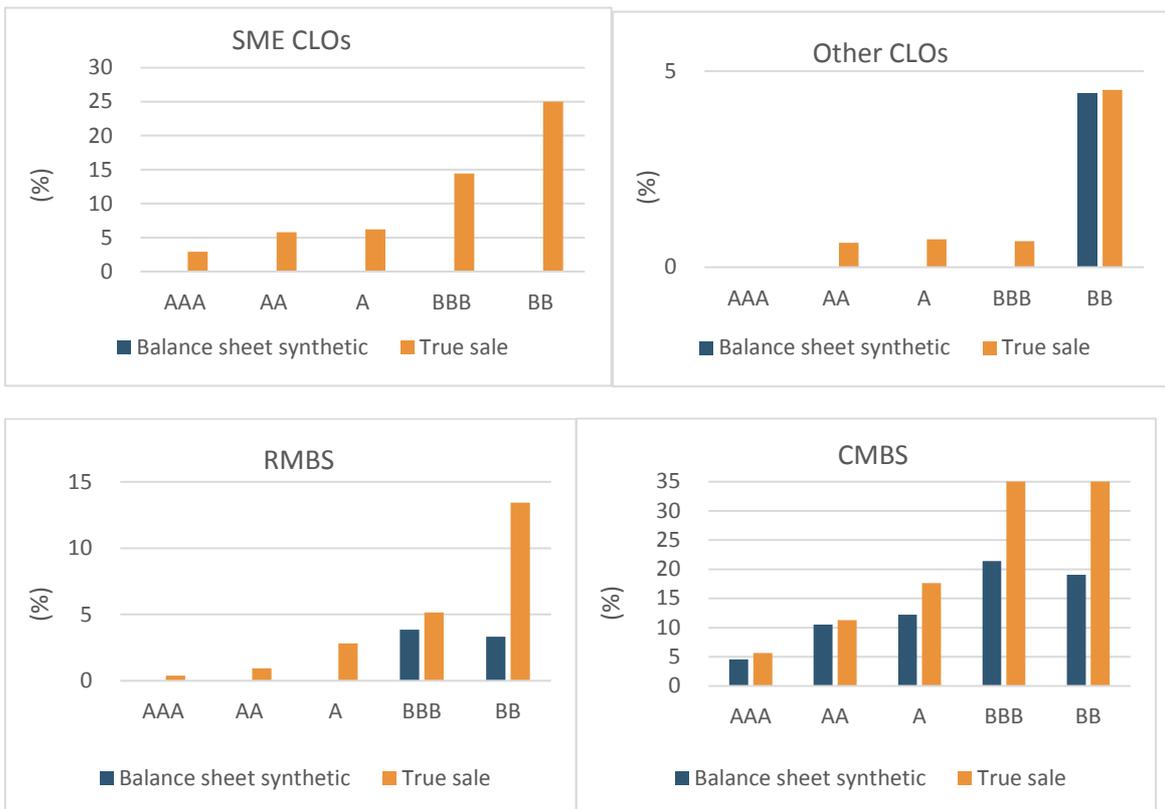
50. The balance sheet synthetics have performed better than traditional securitisations, for all asset classes (SMEs CLOs, RMBS, CMBS, and other CLOs).

Figure 16: Lifetime Default Rates, selected asset classes (as of end 2018)



51. The same applies for all the rating grades. The default performance of balance sheet synthetics is better than that of the traditional securitisation, for all selected asset classes (all as of end 2018).

Figure 17: Lifetime Default Rates, all rating grades of selected asset classes (as of end 2018)



52. The figure below compares balance sheet synthetic tranches to true-sale tranches rated by S&P per asset class, using the average number of notches of rating transition over the life of the tranche as a measure of average credit quality change incurred by the tranches. Balance sheet synthetic tranches appear to perform better than true sale tranches, with the exception of asset class of ‘other CLOs’.

Figure 18: Lifetime average change in credit quality, selected asset classes (as of end 2018, defined as average number of notches rating transition over the life of the security to date, source: S&P)



53. When interpreting the data, at least the following data limitations should be taken into account with respect to their overall representativeness of the whole synthetic market:

- a. The data only cover rated transactions (i.e. are only partially representative of the market, in particular after the financial crisis). Mostly representative of the pre-crisis market.
- b. The data show the number of ratings but not the volume.
- c. Comparing (balance sheet) synthetic transactions with true sale transactions within a specific asset class and a specific jurisdiction is typically problematic due to sample size issues, as within jurisdictions and/or specific asset classes, there tends to be a bias towards one specific type of securitisation either the true sale or the synthetic one.
- d. Definition of lifetime default may not be standardised across all institutions (i.e. there may be differences in how the lifetime default is interpreted).
- e. The type of underlying collateral, the vintage of the transaction and the business cycle conditions in the jurisdiction of issuance are factors, that likely contribute to determining the better performance of balance sheet synthetics as pictured by the figures, while the transactions included in the traditional securitisation sample are more biased towards jurisdictions more severely hit by the crisis and/or lower quality underlying collateral.

54. The data from S&P suggest that from a methodological perspective do not provide any evidence that would support an ex ante expectation of worse performance of the synthetic securitisation instrument, as opposed to the traditional securitisation instrument, once the other mentioned risk drivers are accounted for.

55. The data from IACPM show that there are zero default and loss rates on senior tranche, for significant majority of reported transactions and asset classes. This is with the exception of SMEs, where the average annual default rate on 21 reported transactions is 0.11%, and annual

loss rate is 0.02%. In any case, the maximum annual default rate for individual transactions is 1.6%.

Figure 19: Cumulative observed defaulted amount + loss amount at 31.12.2018 on the senior tranche divided by senior tranche size at inception and divided number of years elapsed (to measure realised annual default rate + realised annual loss rate, source: IACPM)

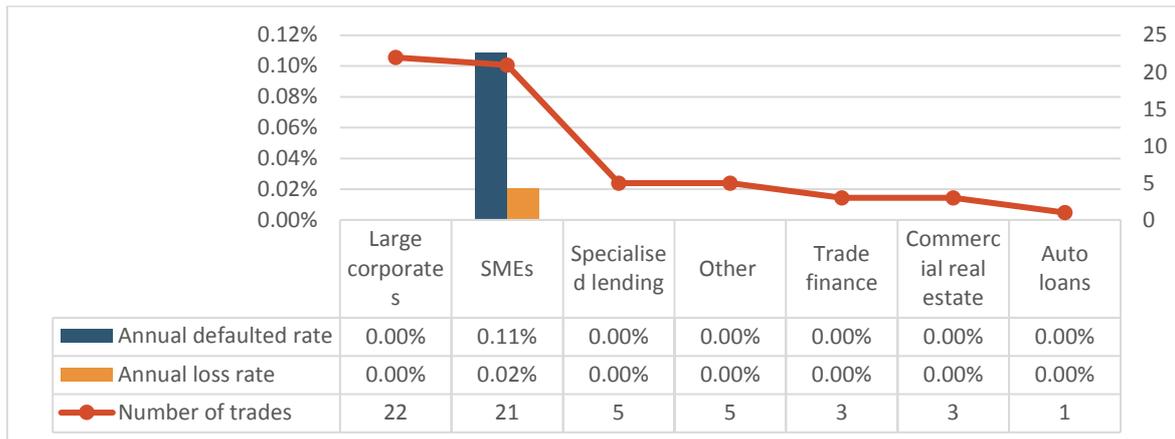
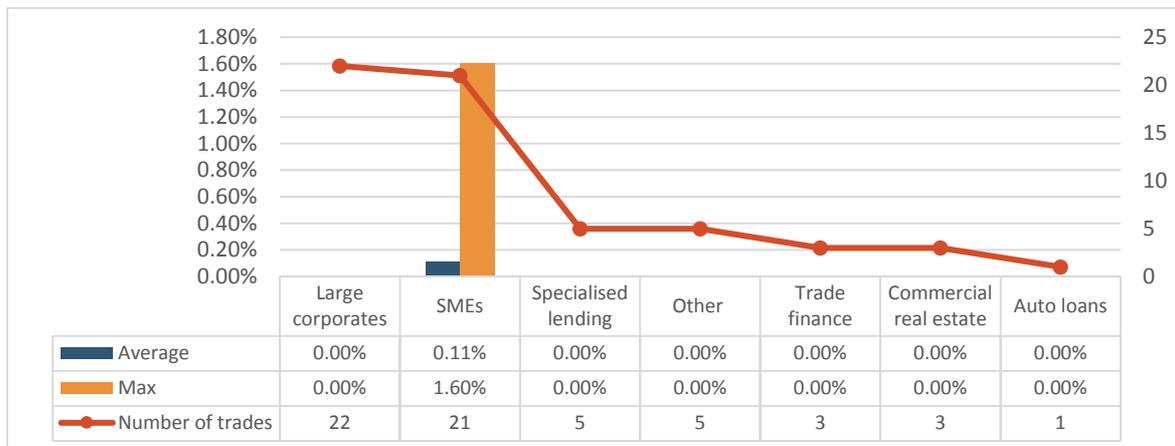


Figure 20: Realised annual default rate for senior tranche: Average & Max



56. The default and loss rates are slightly higher when considering the whole portfolio (i.e. all tranches and not senior tranches only). The default and loss rates are highest for SMEs, and followed by specialised lending.¹² Average annual default rate for SMEs is 0.59%, while maximum reported amount is 1.77%. With respect to average annual default rates for other asset classes, the value is in every case below 1%.

¹² If we disregard the asset category ‘others’, which includes particular and specific types of deals (such as, equity bridge finance, leveraged buyout loans, leveraged buyout revolving facilities, and mix of specific asset classes). Specialised lending category include project finance, infrastructure project finance loans, structured lending and similar.

Figure 21: Cumulative observed defaulted amount + loss amount at 31.12.2018 on the securitized portfolio divided by Trade size at inception and divided number of years elapsed (to measure realised annual default rate, and realised annual loss rate, source: IACPM)

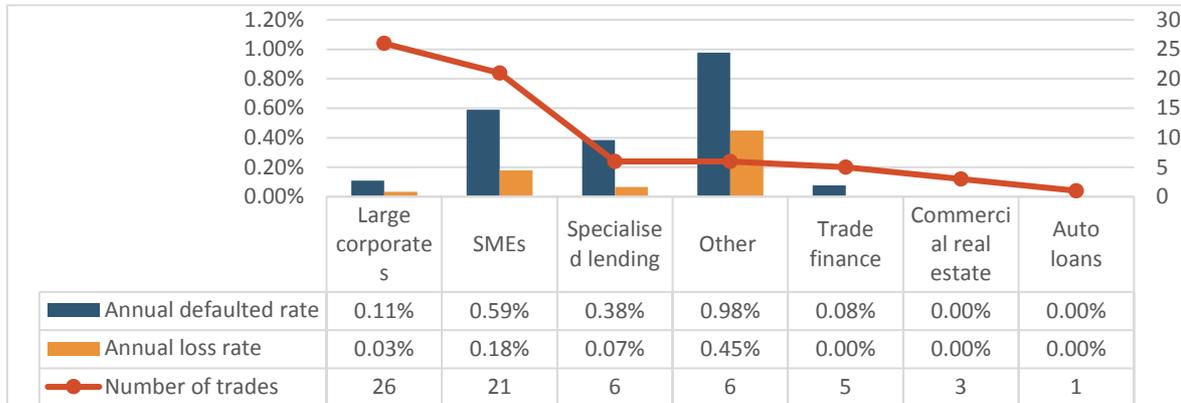
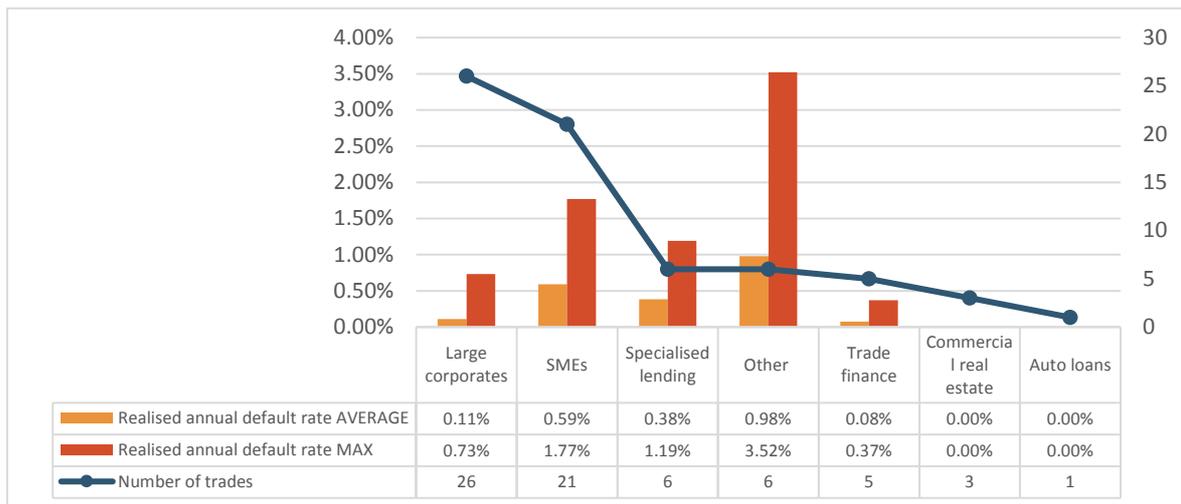


Figure 22: Realised annual default rate: average & max (source: IACPM)



57. Both default and loss rates are significantly lower than those for comparable portfolios (comparable portfolios are defined in the sample as portfolios from the same business division, or using the same rating model as the securitised pool). This indicates that the originators tend to systematically choose 'core' exposures for the synthetic securitisation, with better default and loss performance than for comparable exposures held on the balance sheet.

Figure 23: Default rate: Realised annual default rate, realised annual default rate on senior tranche and observed annual default rate on a comparable but broader portfolio of the bank, at 31.12.2018 (e.g. from the same business division, or using the same rating model as the securitized pool, source: IACPM)

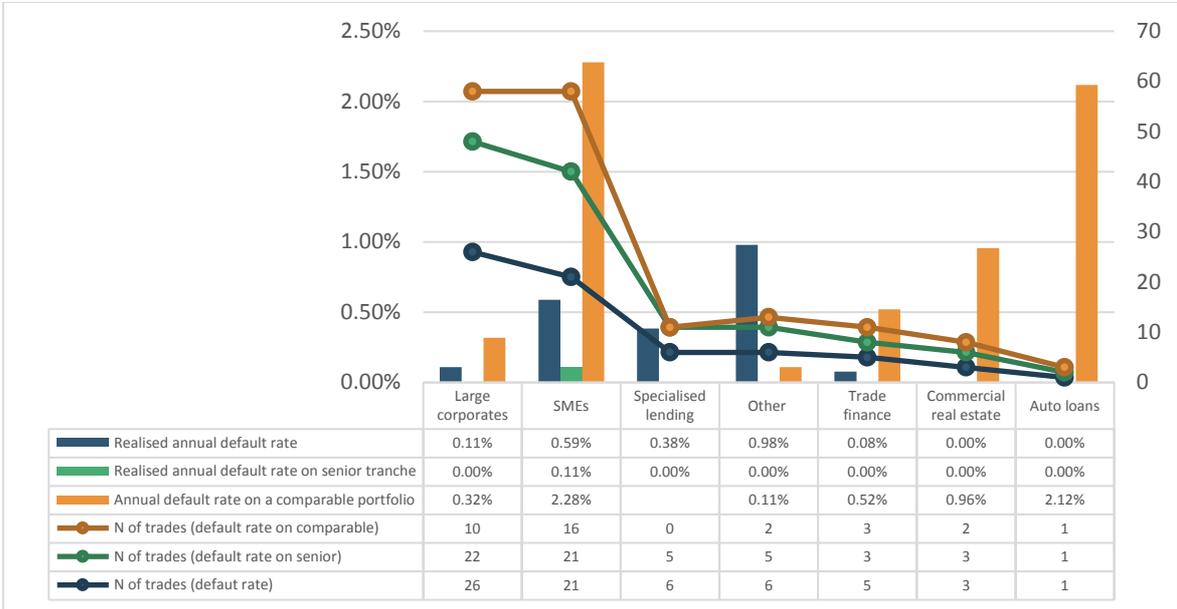
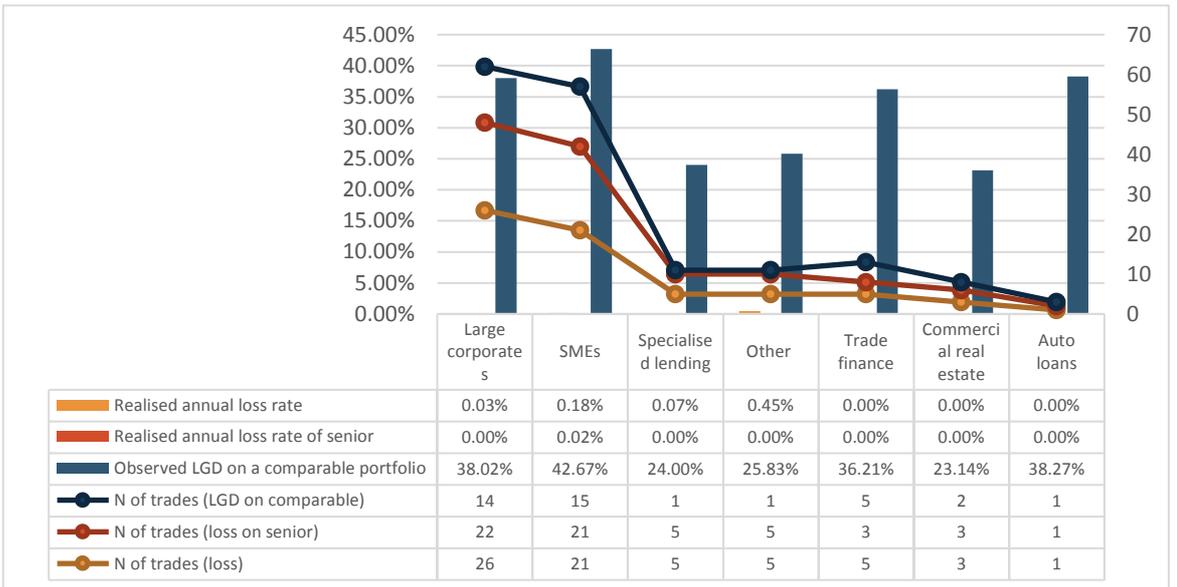


Figure 24: Loss rate: Realised annual loss rate, Realised annual loss rate on senior tranche, and Observed LGD on a comparable but broader portfolio of a bank



58. When interpreting the data, data limitations should be taken into account, in particular:

- a. The fact that, although covering a significant portion of the current synthetic market, the number of trades is limited (to 70 transactions);
- b. There is limited information on how the institutions in the sample identified comparable portfolios;

- c. Relatively large part of the sample of transactions was originated in 2017 and 2018 and underlying exposures have not gone through the default-cycle yet.

Question 3: Do you agree with the analysis of the historical performance? Please provide any additional relevant information to complement the analysis.

5.3 Rationale

59. This section provides assessment of a potential rationale for the development of the STS framework for synthetic securitisation.

60. Before such assessment, the following aspects should be particularly considered: (i) first, changed landscape: market and regulatory developments and increased data availability since the development of STS framework for traditional securitisation; (ii) second, specificities of synthetic securitisation compared to traditional securitisation.

5.3.1 Changing regulatory and market environment

61. The first, and crucial aspect, to consider in the context of assessment of the STS framework for synthetics, is the changed landscape in which the synthetic market operates, both in terms of regulatory and market developments.

62. First, all types of securitisations, including synthetic securitisation, are now subject to strict and comprehensive regulation. The Securitisation Regulation, applicable since 1 January 2019, has replaced and strengthened the rules previously determined by a large number of EU acts and introduced additional requirements, leading to creation of stringent and comprehensive framework for regulation of all securitisation products. These include enhanced rules on risk retention, due diligence by investors, credit granting, substantially strengthened transparency requirements, as well as new rules such as those preventing adverse selection of assets with higher credit risk profile into securitisation, ban on resecuritisation and last but not least strict sanctioning regime for negligence or intentional infringement of the rules. Any securitisation issued from January 2019 should therefore be compliant with substantially stricter regulatory requirements than those applicable to securitisations a few years ago.

63. In addition, the EBA has increased its monitoring role of the securitisation market. Under the EBA guidelines on SRT, the competent authorities submit annually to EBA notifications of all the SRT transactions that have been subject to their comprehensive review. In the period from July 2014, the EBA has received notifications on altogether 142 synthetic transactions with a total notional amount of 199 bn EUR, which provide interesting quantitative information on the structure of the deals.

64. A second important development compared to the recent past is the increasing volume, availability and comprehensiveness of data on the synthetic securitisation. The data available now, covering a period of 10 years since the financial crisis, allow for more comprehensive and thorough assessment of volume and performance of the market (although the limitation of the data needs to be taken into account; see the section above for further information on the available data).

65. In addition, the quantity of available data on synthetic securitisation will increase even more in the immediate future, in the context of the enhanced transparency requirements under the Securitisation Regulation. The transparency requirements, and the standardised disclosure

templates developed by ESMA, are applicable to both traditional and synthetic securitisation and provide very detailed information on both underlying exposures as well as on the securitisation structure and counterparties. Public securitisations must complete all templates, while private securitisations are required to comply with the underlying exposure templates only. While for the private transactions, the disclosure templates will not be published and publicly available in the securitisation repositories, the disclosure templates will still need to be used bilaterally between parties of the deal and may be accessed by both the supervisors and the ESAs.

66.Third, the evidence available on the recent and ongoing market trends increase the relevance of the potential STS framework. The observed market practices indicate a trend towards increasing standardisation in the synthetic market, as well as growing appetite for harmonisation of this market segment. One of major incentives in the recent months has been the publication of the EBA Discussion Paper on the Significant Risk Transfer in September 2017¹³, which has stimulated debate and discussion in the synthetic securitisation market. The EBA proposals put forward in the discussion paper, both on the structural features of the transactions and on the amount/quantitative features of the transferred risk, have affected the transactions in the market, and have also had impact on assessment of SRT by some competent authorities. This indicates there is a scope for further standardisation of the structural features of the synthetic securitisation. This has also been noticeable in the market responses to the discussion paper, where two common theses have been observed: (i) a strong preference for harmonisation and level playing field; (ii) desire to ensure that any rules are workable and effective for the market.

67.The evidence available from different sources suggests that market has been reviving in the recent years, overcoming the stigma that has been associated with the synthetic securitisation in the post-crisis period. The trends suggest that there is sound appetite and potential for growth of the synthetic market on the originator side (indicated for example by the PCS Label for synthetics that has been introduced in 2017 and is being assigned to synthetics since then).

68.Overall, the developments in the last few years have strengthened a foundation for the future growth of the synthetic sector, and the relevance of a STS regulatory framework.

5.3.2 Specificities of synthetic and traditional securitisation

69.While synthetic securitisation and traditional (i.e. ‘true sale’) securitisation may not fundamentally differ in terms of the nature of the underlying exposures, risk tranching and capital (waterfall) structures, there is important difference between the ways of transferring risk from the originator to the investor. While traditional securitisation realises this transfer by transferring the actual underlying exposures as well as their ownership to a securitisation special purpose entity (SSPE), synthetic securitisation realises the risk transfer by means of a credit

¹³ EBA Discussion Paper on Significant Risk Transfer, September 2017: <https://eba.europa.eu/regulation-and-policy/securitisation-and-covered-bonds/discussion-paper-on-the-significant-risk-transfer-in-securitisation>

protection contract between the originator and the investor, leaving the underlying exposures in the ownership of the originator and on its balance sheet.

70. In synthetic securitisation, therefore, the actual extent of risk transfer depends not only on the capital structure of the transaction (i.e. the tranching), and on potential mechanisms of support from the originator (as it is the case in traditional securitisation), but also on the features of the credit protection contract on which the originator and investor agree, and on the creditworthiness of the investor.
71. An inherent aspect of the transfer of credit risk of the exposures which remain on the originator's balance sheet is that the parties in the synthetic securitisation are 'communicating vessels', in contrast to traditional securitisations where due to the true sale the originator transfers both the risk and ownership of the exposures to SPV and the links between the originator and the investor are therefore less relevant. Therefore, while the regulation of traditional securitisation (including the STS framework) is mostly focused on the protection of investor, in case of synthetic securitisation the regulation (and any potential the STS framework) should focus both on the originator and the investor. Mitigating the risks involved in the synthetic securitisation is thus as important for the originator's positions as it is for the investor's positions. In synthetic securitisation, different contractual features can potentially result in very different degrees of protection for, the originator and the investor. In particular, in a context where both the originator and the investor in a synthetic transaction are credit institutions, different contractual features can significantly bias the credit protection arrangement in favour of a prudentially stronger, significant risk transfer process for the originator and to the disadvantage of the investor, or vice versa.
72. The synthetic securitisation also tend to be easier to execute compared to traditional securitisation. Originators may be incentivised to use the synthetic rather than traditional securitisation due to the greater flexibility of the synthetic mechanism, which is cheaper in terms of costs, and quicker to arrange. It also allows the originator to avoid the legal and operational difficulties that can be incurred in a true sale transaction related to the transfer of ownership of the underlying exposures. Synthetic securitisations also allow the originators to address confidentiality issues related e.g. to the obligors' identity or commercial secrets. Compared to traditional securitisation, it is therefore also easier to mix asset classes and exposures from different jurisdictions to increase diversification and granularity of the portfolio.
73. From a regulatory/supervisory perspective, compared to traditional securitisation, synthetic 'balance sheet' securitisation exposes the investor (protection provider) to the pure credit risk of the underlying exposures. In particular, risks stemming from the cash flow profile of the securitisation, such as pre-payment risk and interest risk, are less relevant for the investor's position, as the cash flows from the underlying exposures are not passed on to investors (i.e. they are not used to pay the premium/guarantee fee payments owed to the investors). In addition, the legal risks relating to the transfer of ownership and segregation of the underlying exposures (claw back risk etc.) are not applicable within the synthetic securitisation environment.

74. The counterparty credit risk potentially arising in the credit protection contract is the only element of complexity, from a transaction structure perspective, that is specific to synthetic securitisation. Counterparty credit risk may arise for the originator of the transaction (the protection buyer) due to the risk of default (or other events) in relation to the investor (the protection seller), resulting in the lack of credit protection. Counterparty credit risk may also arise for the investor (protection seller) due to the risk of default (or other events) in relation to the originator, resulting in missed premium/fee payments by the originator and, where applicable, the loss of collateral posted by the investor to the originator or to a third party to fund the credit protection.

75. Any STS framework would therefore need to be adapted to the specificities of the synthetic securitisation, in particular with respect to different specific risks (in particular counterparty credit risk), specificities of the credit transfer, and different motivations for both originators and investors to engage in the synthetic securitisation.

5.3.3 Assessment of pros and cons of the STS framework for synthetics

76. The assessment of STS framework for synthetics should include two separate discussions:

- a. First, discussion on the 'first stage' i.e. on the possibility of development of STS synthetic product, i.e. product that would be able to meet the 'qualifying' criteria ensuring simplicity, standardisation and transparency and specific criteria for synthetic securitisation, capturing all main risk drivers not related to the underlying exposures.
- b. Second, a separate discussion on the 'second stage' i.e. on the potential more risk-sensitive regulatory treatment of such STS product.

77. These discussions should be perceived as separate i.e. it may be possible to develop a framework for STS synthetic product without introducing more risk-sensitive regulatory treatment of such instrument.

78. As a starting point, both analysis acknowledge technical feasibility of creation of the STS product: i.e. they take into account that the structure of the synthetic securitisation allows to replicate that of traditional securitisation, including the STS traditional securitisation, in terms of mitigating the main drivers of risk such as agency and model risks that are not linked to underlying exposures. As a result, it is acknowledged that the synthetic structure allows to align the performance of synthetic securitisation with those of traditional securitisation of the same asset class, and that from a technical perspective, there is no evidence that would suggest that synthetic securitisation structure inherently results in higher losses than traditional securitisation structure.

5.3.4 Pros and cons of the development of STS synthetic product

79. The analysis below provides an assessment of the pros and cons of the development of STS synthetic product.

Pros	Cons
Increased transparency of the product	STS balance sheet synthetic framework has not been developed at global level (IOSCO/BCBS)
Increasing relevance of the product in the context of ongoing regulatory developments	Could be perceived as a high quality label by less sophisticated market players
Increased relevance of the product due to some advantages compared to traditional securitisation	Could lead to less issuance of traditional STS securitisations
Further standardisation of the product and opening of the market for smaller originators and investors	
Importance of regulatory endorsement for the revival of the market	
Potential positive impact on the financial and capital markets, financial stability and on the real economy	

Pros

80. *Increased transparency of the product:* The STS framework would be targeted to ensure that all the risks arising in the synthetic securitisation are properly addressed, including risks related to the overall complexity, riskiness and information asymmetries of the securitisation structure. This would prevent the risks of arbitrage, fraud and risks related to lack of transparency that were linked with some synthetic deals in the pre-crisis period. This should facilitate the assessment of the risks of the securitisation transaction by the investor. All in all, STS framework should protect the synthetic securitisation from future crisis, and should thus have a positive impact on the financial stability.

81. *Increasing relevance of the product in the context of current regulatory developments:* The relevance and attractiveness of synthetic securitisation as a credit risk and balance sheet management tool remains relevant in a more complex operating environment also due to recent regulatory developments, which enhance requirements for banks' balance sheet management. These include in particular the following regulatory developments: (i) Basel III framework approved in December 2017 and applicable from 2022, including strengthened capital requirements, revisions to the leverage ratio, and introduction of the output floor; (ii) requirements under accounting reform IFRS9; (iii) exposure management requirements; (iv) changes in the context of the fundamental review of the trading book. These changes may lead to, on the one hand, increased demand by banks for equity, and equity-linked or TLAC instruments, and on the other hand, increased focus by banks on a better balance sheet management through the available credit management tools.

82. *Increased relevance of the product due to some advantages compared to traditional securitisation:* As mentioned above, synthetic securitisation provides more flexibility than traditional securitisation and helps to overstep administrative, legal and operational constraints

involved in traditional securitisation. It allows to securitise greater spectrum of exposures and free up capital more quickly. This is especially relevant for securitisation of SME loans.

83. Further standardisation of the product and opening of the market for smaller originators and investors: The STS framework would enhance the standardisation of the product. This should result in more investor confidence in the securitisation product and help overcome the post-crisis stigma that the market has attracted. Standardisation of the product would also help open the market, and reduce the entry barriers, for less sophisticated banks on the originator side as well as smaller players on the investment side.

84. Importance of regulatory endorsement for the revival of the market: Feedback from a number of stakeholders indicates that regulatory endorsement of the synthetic product going hand in hand with the harmonisation and standardisation, is of crucial importance for the originators for the destigmatisation, economic viability and revival of the market. It would stimulate more banks to issue synthetics (as they will have to keep less capital on retained tranches) and this in turn would increase the investor base.

85. Potential positive impact for financial and capital markets, financial stability and real economy: Synthetic securitisation can bring important benefits for the capital markets and the real economy. It has a potential to improve efficiencies in the financial system and enhance the financial stability of financial sector as a whole. Some of the systemic benefits, that may otherwise not be available through alternative forms of capital (equity, AT1, etc.), are the following:

- a. The synthetic securitisation provides for the second pair of eyes for analysis of the pool: To the extent that the pool of performing exposures is representative of the bank overall exposure in that area, the fact that the bank is able to execute a deal indicates that the underwriting quality and the bank systems and processes stand up to the due diligence of an investor.
- b. If soundly structured, it can provide an alternative funding channel and risk diversification tool for the banks, it can be used as an instrument for hedging of tail risk in economic downturn and it can enable the risk transfer from banks to non-bank entities and hence to facilitate allocation of risk more widely within the Union financial system.
- c. The synthetic securitisation has notable potential to free up originators' balance sheets to allow for further lending to the economy. This may be relevant for the revival of the SME lending.

Cons

86. Not developed at global level (IOSCO/BCBS): The existing Basel STC framework only covers traditional securitisation and is not extended to synthetic securitisation. An STS framework for

synthetic securitisation could lead to a super-equivalent regime with additional operational issues for originators and investors.

87. Other potential negative effects: There may be other potential negative consequences, such as potential confusion of the market with two-layer structure (STS/non-STS versus traditional/synthetic), and increased moral hazard risk due to market perception (by less sophisticated market players) that the STS label inherently means high quality product. It could also lead to less issuance of traditional STS securitisations, or to further STS developments later on such as developments of STS NPL securitisations.

5.3.5 Pros and cons of the introduction of more risk-sensitive regulatory treatment of the STS synthetic product

88. The analysis below provides assessment of the ‘second stage’ of the STS framework i.e. of the potential differentiated regulatory treatment of such STS product.

Pros	Cons
Stimulation of development of STS product; more in line with actual performance of balance sheet synthetics, more risk sensitive regulatory framework	Non-compliant with Basel STS: no balance sheet synthetic framework and no preferential treatment has been developed at global level (IOSCO/BCBS)
Overcoming constraints of current limited STS risk weight treatment of SME synthetic securitisations	Potential risks for the banking sector
Ensuring regulatory playing field with the traditional securitisation	
Fuelling the potential positive impact of the synthetic securitisation on the financial markets and stability	

Pros

89. Stimulation of development of STS product: Regulatory recognition in the form of more sensitive regulatory treatment (such as lower risk weights) can be considered a natural implication of development of STS product which is simpler, more standardised and more transparent than other types of synthetic securitisation, as well as of the good historical performance of the synthetic securitisation.

90. Overcoming constraints of current limited STS risk weight treatment of SME synthetics: The practicability of the provisions on STS treatment of synthetic securitisation of SME portfolios in Art. 270 of the CRR is limited. The synthetic securitisation needs to meet the STS criteria that have been specifically designed for traditional securitisation and cannot/are difficult to be applied to synthetic product.

91. Ensuring level playing field: Development of two-stage STS framework for synthetics would ensure a level playing field with similar treatment of the traditional securitisation.

92. Fuelling the potential positive impact of the synthetic securitisation on the financial markets and stability: The regulatory recognition of the STS product, and expected increase in demand and

issuance, would further enhance the potential positive impacts of the synthetic securitisation. For example, the banks' lending capacity would be increased, more capital would be able to be freed up for further lending to economy and more risk would be transferred to be spread across the financial system.

Cons

93. *Non-compliant with Basel:* One of the main deficiencies of the STS framework for synthetics is that it would not be Basel compliant. The existing Basel STC framework only covers traditional securitisation and is not extended to synthetic securitisation. It is also unlikely that such framework – in particular the more risk sensitive regulatory treatment - will be developed in the future, taking into account that no consensus has been reached between Basel members, including the United States. On the other hand, the deviations from Basel are not without precedence (for example, the EU extends more favorable treatment to covered bonds than Basel).

94. *Potential risks for the banking sector:* Introduction of lower capital requirements for banks may increase the opportunistic behavior of banks, and increase the motivation for banks to engage in securitisation for capital benefits. This could lead to introducing excessive leverage into the originator's balance sheet that is inherent in synthetic securitisation, and potentially have negative impact on the stability of the bank.

Question 4: Do you agree with the analysis of the rationale for the creation of the STS synthetic instrument? How useful and necessary is synthetic securitisation for the originator and the investor? What are the possible hurdles for further development of the market?

Question 5: Do you agree with the assessment of the reasons that could eventually support a preferential capital treatment?

Question 6: Please provide any additional relevant information on potential impact of the creation of the STS synthetic securitisation on (STS) traditional securitisation, and any other information to complement the analysis.

5.4 Criteria for STS synthetic securitisation

5.4.1 Introduction

95. This chapter sets out the proposed criteria in order for synthetic securitisations to fall under the 'STS' synthetic securitisation framework.

96. When developing the criteria, the objective has been to achieve a high degree of consistency with the existing STS criteria for the traditional securitisation, so as to ensure the following:

- a. that the overall complexity and riskiness of the securitisation structure is appropriately mitigated;
- b. that the introduction of an STS framework for synthetic securitisation should not advert the incentives of an originator when adopting a certain securitisation technique (e.g. it should not incentivise the originator to securitise in a synthetic format the exposures that, due to specific features of riskiness, are not eligible under STS framework for traditional securitisation).

97. The proposed STS criteria for synthetic securitisation have been designed taking into account additional objectives as compared to STS criteria for traditional non-ABCP securitisation: while the STS framework for traditional securitisation is primarily designed from the perspective of the investor so as to ensure the investor protection (as the protection of the originator is less relevant due to the true sale/transfer of the exposures), the STS framework for synthetic securitisation is designed to ensure the protection of both the originators and investors (as the originator usually acts as investor of the senior tranche, the securitised exposures remain the exposures on the balance sheet of the originator and both parties have exposures to the counterparty credit risk).

98. The criteria have been developed by taking the STS criteria for traditional securitisation as a basis. The criteria have been adapted as follow:

- a. A set of criteria for STS traditional securitisation, that are not workable in synthetic securitisation transactions due to inherent differences from traditional technique, have been eliminated or adapted;
- b. A set of new criteria have been introduced, specific to synthetic securitisation, as follows:
 - i. Ensuring that the STS framework only targets balance sheet synthetic securitisation, as opposed to arbitrage securitisation;
 - ii. Ensuring that the credit protection agreement is structured to adequately protect the position of both the originator and the investor from a prudential perspective;

- iii. Addressing counterparty credit risk for both the originator and the investor.

99. The following table provides an overview of the STS criteria and the comparison with the STS criteria for traditional securitisation. The italic font in the content of each criterion indicates the difference compared to similar STS criterion for traditional securitisation.

Figure 25: Overview of STS criteria and comparison with STS criteria for traditional securitisation

Criterion	Synthetic securitisation	Comparison with criteria for traditional (non-ABCP) securitisation (references to Articles in Securitisation Regulation)
Simplicity	Criterion 1: Balance sheet synthetic securitisation, credit risk mitigation	Replacement of the criterion on true sale/assignment/assignment at later stage, clawback provisions, representations and warranties on enforcement of true sale (Art. 20(1) – (5) of the Securitisation Regulation) – with definition of balance sheet synthetics and requirement to ensure robustness of credit protection contract (credit risk mitigation criteria)
	Criterion 2: Representations and warranties	Adaptation of the the criterion on representations and warranties (Art. 20(6): extension of the required representations and warranties and adaptation of their objective and content
	Criterion 3: Eligibility criteria, no active portfolio management	Adaptation of the criterion on eligibility criteria, no active portfolio management (Art. 20(7)): adaptation of allowed portfolio management techniques, inclusion of additional conditions for removal of the underlying exposures in securitisation
	Criterion 4: Homogeneity, enforceable obligations, full recourse to obligors, period payment streams	Similar to criterion on homogeneity, enforceable obligations, full recourse to obligor, periodic payment streams, (Art. 20(8))
	Criterion 5: No transferable securities	Similar to criterion on transferable securities (Art. 20(8))
	Criterion 6: No resecuritisation	Similar to criterion on no resecuritisation (Art. 20(9))
	Criterion 7: Underwriting standards and material changes thereto	Adaptation of the criterion on underwriting standards and material changes thereto (Art. 20(10): additional clarification with respect to the types of eligible obligors and with respect to the underwriting of the underlying exposures
	Criterion 8: Self-certified loans	Similar criterion on self-certified loans (Art. 20(10))
	Criterion 9: Borrower's creditworthiness	Similar to criterion on borrower's creditworthiness (Art. 20(10))
	Criterion 10: Originator's expertise	Similar to criterion on originator's expertise (Art. 20(10))
	Criterion 11: No defaulted exposures or exposures subject to outstanding disputes	Similar to criterion on no defaulted exposures (Art. 20(11))
	Criterion 12: At least one payment made	Similar to criterion on at least one payment made (Art. 20(12))
	Criterion 13: No embedded maturity transformation	Similar to criterion on no predominant dependence on the sale of assets (Art. 20(13))

Standardisation	Criterion 14: Risk retention requirements	Similar to criterion on risk retention requirements (Art. 21(1))
	Criterion 15: Appropriate mitigation of interest rate and currency risks	Adaptation of the criterion on appropriate mitigation of interest rate and currency risks (Art. 21(2)): to further specify measures for appropriate mitigation of interest rate and currency risks, adapted to synthetic securitisation
	Criterion 16: Referenced interest payments	Similar to criterion on referenced interest payments (Art. 21(3))
	Criterion 17: Requirements after enforcement/acceleration notice	Adaptation of the criterion on requirements after enforcement/acceleration notice (Art. 21(4)): adapted to reflect that not all synthetic securitisations use SSPE
	Criterion 18: Allocation of losses and amortisation of tranches	Adaptation of the criterion on requirements for non-sequential priority of payments (Art. 21(5)): adapted with additional requirements for pro rata amortisation and allocation of losses
	Criterion 19: Early amortisation provisions/triggers for termination of the revolving period	Adaptation of the criterion on early amortisation provisions/triggers for termination of the revolving period (Art. 21(6)): adapted with requirements for early amortisation only in the case of the use of an SSPE
	Criterion 20: Transaction documentation	Adaptation of the criterion on transaction documentation (Art. 21(7)): with additional requirements for servicing standards and procedures
	Criterion 21: Servicer's expertise	Similar to criterion on servicer's expertise (Art. 21(8))
	Criterion 22: Reference register	Replacement of the criterion on definitions, remedies in the transaction documentation (Art. 21(9)): requirements for the transaction documentation to specify payment conditions is covered in separate criteria
	Criterion 23: Timely resolution of conflicts between investors	Similar to criterion on timely resolution of conflicts between investors (Art. 21(10))
Transparency	Criterion 24: Data on historical default and loss performance	Similar to criterion on data on historical default and loss performance (Art. 22(1))
	Criterion 25: External verification of the sample	Similar to criterion on external verification of the sample (Art. 22(2))
	Criterion 26: Liability cash flow model	Similar to criterion on liability cash flow model (Art. 22(3))
	Criterion 27: Environmental performance of assets	Similar to criterion on environmental performance of assets (Art. 22(4))
	Criterion 28: Compliance with transparency requirements	Similar to criterion on compliance with transparency requirements (Art. 22(5))
Requirements specific to synthetic securitisations	Criterion 29: Credit events	N/A
	Criterion 30: Credit protection payments	N/A
	Criterion 31: Credit protection payments following the close out/final settlement at the final legal maturity of the credit protection agreement	N/A
	Criterion 32: Credit protection premiums	N/A
	Criterion 33: Verification agent	N/A
	Criterion 34: Early termination events	N/A

	Criterion 35: Excess spread	N/A
	Criterion 36: Eligible credit protection agreement, counterparties and collateral	N/A

100. Following is the set of individual STS criteria for synthetic securitisation. It should be clarified that as the criterion 1 requires that the protection buyer under the credit protection arrangements is an originator with respect to the securitised exposures, and given that according to the sponsor definition pursuant to Article 2(5) of the Securitisation Regulation only credit institutions or investment firms other than the originator can qualify as a sponsor, all the obligations specified for originator and sponsor in STS criteria for traditional securitisation have been limited to the originator in the STS criteria for synthetic securitisation.

101. In addition, to further enhance the consistency between the STS framework for synthetic and traditional securitisation, as well as to facilitate the uniform application of any STS framework for synthetic securitisation, the EBA recommends that the criteria should be further clarified by the issuance of respective STS guidelines.

5.4.2 Simplicity criteria

Criterion 1:	Balance sheet synthetic securitisation, credit risk mitigation
Comparison with the criterion for traditional securitisation:	Replacement of the criteria in Art. 20(1)-(5) with definition of balance sheet synthetics and requirement to ensure robustness of credit protection contract (credit risk mitigation criteria)

Content of the criterion:

General requirements for balance sheet securitisation:

In order to be considered STS synthetic balance sheet securitisation the following requirements should be met:

1. *The securitisation should be a **synthetic securitisation** as defined in Article 2(10) of the Securitisation Regulation.*
2. *The protection buyer under the credit protection arrangements establishing the synthetic securitisation is **an EU-regulated undertaking** as defined under points (a) to (g) of Article 2(12) of the Securitisation Regulation, and is an **originator** with respect to the underlying exposures as defined in Article 2(3) of the Securitisation Regulation.*
3. *When the protection buyer is an originator with respect to the underlying exposures as defined in point (b) of Article 2(3) of the Securitisation Regulation i.e. the exposures underlying the synthetic securitisation have been purchased from a third party before they are securitised, the originator should apply to the purchased exposures credit and collection policies, workout policies and servicing policies that are no less stringent than*

those the originator applies to similar exposures that have not been purchased.

4. *The underlying exposures are part of the **core lending or any other core business activity of the protection buyer.***
5. *The underlying exposures should be **held on the balance sheet of the protection buyer,** at or before the closing date.*
6. *The protection buyer should undertake in the securitisation documentation to **not further hedge** its exposure to the credit risk of the underlying exposures beyond the credit protection obtained through the synthetic securitisation in a manner that results in the double hedging of the same credit risk.*

Credit risk mitigation rules:

The credit protection agreement establishing the synthetic securitisation should comply with the credit risk mitigation rules laid down in Article 249 of the amended CRR (including the requirements on SSPE), or with equivalently robust requirements in case the protection buyer is not an institution regulated under the CRR.

Rationale for the criterion:

The objective of the criterion is to set out requirements for balance sheet synthetic transactions, i.e. those transactions where the regulated institution's primary objective is the transfer of credit risk of exposures that the regulated institution itself holds on balance sheet. The ultimate object of credit risk transfer should be exposures originated or purchased by the institution within a core lending/business activity of such regulated institutions and held on its balance sheet at the closing date.

This criterion should exclude arbitrage securitisations, i.e. transactions where the protection buyer purchases exposures outside their core lending/business activity, for the sole purpose of writing credit protection on them (i.e. securitising them) and arbitraging on the yields resulting from the transaction. Ensuring that the management of exposures purchased for the purposes of securitising them is consistent with that of similar exposures not securitised is important to avoid the occurrence of moral hazard behaviours by the protection buyer that could result in an overall lesser credit quality of the securitisation transaction, ultimately affecting both retained securitisation positions and securitisation positions placed with investors.

This criterion should also exclude arbitrage transactions where the risk is subject to a double hedge (for example, where more than one credit default swap (CDS) is used to hedge the same credit risk).

In order to ensure legal certainty in terms of the payment obligations, the protection buyer should undertake that it does not hedge the same credit risk more than once by obtaining credit protection in addition to the credit protection provided by the synthetic securitisation for such credit risk.

In order to ensure the robustness of the credit protection agreement such agreement should fulfil the credit risk mitigation requirements in accordance with Article 249 of the amended CRR that have to be met by institutions seeking significant risk transfer through a synthetic

securitisation.

Criterion 2:	Representations and warranties
	Art. 20(6)
Comparison with the criterion for traditional securitisation:	Adapted criterion: extension of required representations and warranties and adaptation of their objective and content to synthetic securitisation

Content of the criterion:

The securitisation documentation should contain the representations and warranties provided by the protection buyer that the following requirements in respect of the underlying exposures of a synthetic securitisation are met:

- **Title to and accounting of the exposures:** Where the protection buyer is a credit institution or insurance company, the protection buyer has full right, good and valid title to the underlying exposures and their associated ancillary rights and accounts for the credit risk of the underlying exposures in his regulatory balance sheet. Where the protection buyer is not a credit institution or insurance company, the protection buyer has full right, good and valid title to the underlying exposures and their associated ancillary rights.
- **Compliance of the exposures with all eligibility criteria set out in the securitisation documentation:** Each underlying exposure meets all eligibility criteria, representations and warranties and any other conditions, other than a credit event, for a protection payment in accordance with the credit protection agreement within the securitisation documentation.
- **Financing agreements' validity and enforceability:** The contractual agreement underlying each exposure contains a legal, valid and binding obligation of the obligor, enforceable in accordance with its terms, to pay the sums of money specified in it.
- **Underwriting standards:** The underlying exposures meet the standard underwriting criteria that are not less stringent than those criteria, which the originator applies to similar exposures that are not securitised.
- **No obligor default or other material breach:** To the best knowledge of the protection buyer none of the obligors with respect to the underlying exposures is in material breach or default of any obligations under any loan agreements.
- **No untrue information:** There is no untrue information on the particulars of the underlying exposures contained in the securitisation documentation.

As at the closing date, in relation to each underlying exposure, no contractual agreement between the obligor and the original lender has been subject to any variation, amendment, modification,

waiver or exclusion of time of any kind which in any material way adversely affects the enforceability or collectability of the underlying exposure.

Rationale for the criterion:

To enhance the legal certainty with respect to the underlying exposures and enforceability with respect to credit protection agreement, the securitisation documentation should contain specific representations and warranties provided by the protection buyer in respect of the characteristics of those underlying exposures and of the correctness of the information included in the securitisation documentation.

Criterion 3:	Eligibility criteria, no active portfolio management
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	Art. 20(7)
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Comparison with the criterion for traditional securitisation:	Adaptation of the criterion: adaptation of allowed portfolio management techniques, inclusion of additional conditions for removal of the underlying exposures in securitisation
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Content of the criterion:

The underlying exposures should at all times be subject to predetermined, clear and well documented **criteria determining their eligibility** for protection under the credit protection agreement establishing the synthetic securitisation.

After the closing date the securitisation should not be characterised by **an active portfolio management** on a discretionary basis including the sale of exposures being protected under the credit protection agreement. The following should in principle not be considered an active portfolio management:

- Substitution of exposures that are in breach of representations and warranties
- *Where the securitisation includes a replenishment period, the addition of exposures that meet clearly defined replenishment conditions.*

In any case, any exposure added to the securitisation after the closing should meet eligibility criteria that are **no less strict** than those applied in the initial selection of underlying exposures at the closing date.

*An underlying exposure may only be **removed** from the securitisation where it:*

- *has been repaid or otherwise matured;*
 - *the underlying exposure is subject to a refinancing, restructuring or similar amendment that is not credit driven, and which occurs in the ordinary course of servicing such exposure (such as, for example, maturity extension);*
 - *where due to an error the underlying exposures did not meet the eligibility criteria at the time it was included in the securitisation.*
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Rationale for the criterion:

Eligibility criteria are essential safeguards in synthetic securitisation transactions as they determine the validity of the credit protection purchased by the protection buyer. Protection buyers and protection sellers should be in a position to identify in a clear and consistent fashion under which criteria exposures are selected to be securitised. The selection should not be an opaque process. Legal clarity over the eligibility for credit protection reduces legal risk.

To enhance legal certainty, additional criteria have been added to limit the conditions under which an underlying exposure may be removed from the securitisation, once it has entered the securitisation under the clearly defined eligibility criteria.

Active portfolio management adds a layer of complexity and increases the likelihood of cherry picking practices occurring, which may undermine the effectiveness of credit protection and hence, increase the risk of the securitisation positions retained by the protection buyer. Active management is deemed to arise whenever the manager of the portfolio sells one or more exposures that were initially included in the securitisation. Replenishment practices and practices of substitution for non-compliant exposures in the transaction due to previous errors in the selection of exposures should not be considered active management of a transaction's portfolio provided that they do not result in any form of cherry-picking.

Replenishment periods and other structural mechanisms resulting in the inclusion of exposures into the securitisation after the closing of the transaction may introduce the risk that exposures of lesser quality could be added to the pool of exposures protected under the credit protection agreement. For this reason, it is important to ensure that any exposure added to the securitisation after the closing meets eligibility criteria that are similar to, and not weaker than those used to structure the initial pool of the securitisation.

Criterion 4:	Homogeneity, enforceable obligations, full recourse to obligor, periodic payment stream
Comparison with the criterion for traditional securitisation:	Art. 20(8) Similar

Content of the criterion:

The underlying exposures should meet the following criteria:

- The synthetic securitisation should be backed by a pool of underlying exposures that are homogeneous in terms of asset type, *subject to conditions clearly defined and specified in the transaction documentation.*
- The underlying exposures should contain obligations of the debtors and, where applicable guarantors, *to pay the sums of money specified in the terms that are contractually binding and enforceable in accordance with such terms*, with full recourse to debtors and, where applicable, guarantors.

- The underlying exposures should have defined periodic payment streams, the instalments of which may differ in their amounts, relating to rental, principal, or interest payments, or to any other right to receive income from assets supporting such payments.
- The underlying exposures may also generate proceeds from the sale of any financed or leased assets.

Rationale for the criterion:

See overarching rationale for consistency with traditional qualifying framework.

As regards the homogeneity, additional homogeneity criteria should be developed to specify the homogeneity in terms of asset type, similarly as has been done for traditional securitisation in the Regulatory Technical Standards on homogeneity which take into account specificities of synthetic securitisation.

Criterion 5:	No transferable securities
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Comparison with the criterion for traditional securitisation:	Art. 20(8) Similar
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Content of the criterion:

The underlying exposures should not include transferable securities, as defined in point (44) of Article 4(1) of Directive 2014/65/EU, other than corporate bonds that are not listed on a trading venue.

Rationale for the criterion:

See overarching rationale for consistency with traditional qualifying framework.

Excluding transferable securities other than corporate bonds that are not listed on trading venue is particularly important in the case of synthetic transactions as it ensures that the proposed STS framework only targets 'balance sheet' transactions, as opposed to 'arbitrage' transactions that were structured in the past to include different types of securities as underlying exposures.

Criterion 6:	No resecuritisation
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Comparison with the criterion for traditional securitisation:	Art. 20(9) Similar
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Content of the criterion:

The underlying exposures should not include any securitisation position.

Rationale for the criterion:

See overarching rationale for consistency with traditional qualifying framework.

The definition of balance sheet synthetic securitisations for STS purposes should exclude resecuritisations. In the past, re-securitisations have been structured into highly leveraged structures where lower credit quality notes could be re-packaged and credit enhanced, resulting in transactions where small changes in the credit performance of the underlying assets severely impacted the credit quality of the re-securitisation tranches. The modelling of the credit risk arising in these bonds proved very difficult, due to high correlations arising in the resulting structures. Synthetic re-securitisations were often structured with arbitrage purposes, and did not serve the credit risk transfer as a primary objective. In addition, unlike synthetic securitisations not structured for arbitrage purposes and not using securitisation positions as underlying exposures, synthetic re-securitisations performed materially worse than traditional securitisation that were structured largely in line with the STS criteria for traditional securitisations.

Criterion 7:	Underwriting standards and material changes thereto
Comparison with the criterion for traditional securitisation:	Art. 20(10) Adaptation of the criterion: additional clarification with respect to the types of eligible obligors and with respect to underwriting of the underlying exposures

Content of the criterion:

The underwriting standards pursuant to which the underlying exposures are originated and any material changes from prior underwriting standards should be fully disclosed to potential investors without undue delay.

The underlying exposures are underwritten with full recourse to an obligor *who is an individual, an SME or a corporate and who is not a special purpose entity.*

No broker intermediary or similar party was involved in the credit or underwriting decisions relating to the underlying exposures.

Rationale for the criterion:

See overarching rationale for consistency with traditional qualifying framework.

Some arbitrage synthetic securitisations have been structured in the past with SSPEs as underlying obligors or involving third parties such as broker intermediaries in the credit or underwriting decisions with respect to the underlying exposures. To ensure that only genuine balance sheet securitisations of underlying exposures that are part of core/business activity of the originator can be eligible under the STS framework, no SSPEs should be allowed as obligors and no broker intermediaries and similar parties should be involved in the underwriting decisions.

Criterion 8:	Self-certified loans
Comparison with the criterion for traditional securitisation:	Article 20(10) Similar

Content of the criterion:

In the case of securitisations where the underlying exposures are residential loans, the pool of loans should not include any loan that was marketed and underwritten on the premise that the loan applicant was made aware that the information provided might not be verified by the lender.

Rationale for the criterion:

See overarching rationale for consistency with the traditional qualifying framework.

Criterion 9:	Borrower's creditworthiness
Comparison with the criterion for traditional securitisation:	Art. 20(10) Similar

Content of the criterion:

The assessment of the borrower's creditworthiness should meet the requirements set out in Article 8 of Directive 2008/48/EC or paragraphs 1 to 4, point (a) of paragraph 5, and paragraph 6 of Article 18 of Directive 2014/17/EU or, where applicable, equivalent requirements in third countries, *to the extent that such standards would, according to their terms, apply to the individual underlying exposures.*

Rationale for the criterion:

See overarching rationale for consistency with traditional qualifying framework.

Criterion 10:	Originator's expertise
Comparison with the criterion for traditional securitisation:	Art. 20(10) Similar

Content of the criterion:

The originator or original lender should have expertise in originating exposures of a similar nature to those securitised.

Rationale for the criterion:

See also overarching rationale for consistency with traditional qualifying framework.

In light of the criterion that requires that the underlying exposures should refer to a core lending/business activity of the originator/purchaser of the credit protection, this criterion appears less relevant in case of synthetic securitisations than in case of traditional securitisations.

It is however still kept as due to strategic decisions institutions may define new core/business activity in respect of which respective expertise has yet to be developed.

Criterion 11:	No defaulted exposures or exposures subject to outstanding disputes
Comparison with the criterion for traditional securitisation:	Article 20(11) Similar

Content of the criterion:

The underlying exposures should not include, at the time of selection:

- exposures in default within the meaning of Article 178(1) of Regulation (EU) No 575/2013, or
- exposures to a credit-impaired debtor or guarantor, who, to the best of the originator's or original lender's knowledge:
 - has been declared insolvent or had a court grant his creditors a final non-appealable right of enforcement or material damages as a result of a missed payment within three years prior to the date of origination of the underlying exposure or has undergone a debt-restructuring process with regard to his non-performing exposures within three years prior to the date of selection of the underlying exposures, except if:
 - a restructured underlying exposure has not presented new arrears since the date of the restructuring, which must have taken place at least one year prior to the date of selection of the underlying exposures; and
 - the information provided by the originator in accordance with points (a) and (e)(i) of the first subparagraph of Article 7(1) of the Securitisation Regulation explicitly sets out the proportion of restructured underlying exposures, the time and details of the restructuring as well as their performance since the date of the restructuring;
 - was, at the time of origination of the underlying exposure, where applicable, on a public credit registry of persons with adverse credit history or, where there is no such public credit registry, another credit registry that is available to the originator or original lender; or
 - has a credit assessment or a credit score indicating that the risk of contractually agreed payments not being made is significantly higher than for comparable exposures held by the originator which are not securitised.

Rationale for the criterion:

See overarching rationale for consistency with traditional qualifying framework.

Criterion 12:	At least one payment made
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Comparison with the criterion for traditional securitisation:	Article 20(12) Similar
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Content of the criterion:

The debtors should, *at the time of inclusion of the respective exposures in the securitisation*, have made at least one payment. This is with exception of revolving securitisations backed by exposures payable in a single instalment or having a maturity of less than one year, including without limitation monthly payments on revolving credits.

Rationale for the criterion:

See overarching rationale for consistency with traditional qualifying framework.

STS synthetic securitisation should minimise the extent to which investors are required to analyse and assess fraud and operational risk. At least one payment should therefore be made by each underlying borrower at the time of inclusion of the respective exposure in the securitisation, since this reduces the likelihood of the exposure being subject to fraud or operational issues, unless in case of revolving securitisations in which the distribution of underlying exposures is subject to constant changes because the securitisation relates to exposures payable in single instalment or with an initial legal maturity of an exposures of below one year.

Examples of exposures to which the requirement of at least one payment being made at the time of inclusion of the exposures in the securitisation does not apply should include: personal overdraft facilities, credit card receivables, trade receivables, trade finance obligations and dealer floorplan finance loans.

Criterion 13:	No embedded maturity transformation
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Comparison with the criterion for traditional securitisation:	Art. 20(13) Similar
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Content of the criterion:

The underlying exposures *should have been underwritten* on the basis that their repayment was not intended to be predominantly reliant on the refinancing of such underlying exposures or on the re-sale value of the assets that are being financed by those underlying exposures.

Rationale for the criterion:

In synthetic securitisations, the payments to the protection provided are not dependent on the cash flows from the underlying exposures and it is therefore not necessary to require that the repayment of investors' securitisation positions is not reliant on refinancing. In the context of

defining balance sheet securitisation, it is however important to ensure that the repayment of exposures is not reliant on their refinancing, as this increases the liquidity risks, market risks and maturity transformation risks to which the securitisation is exposed. It also makes the credit risk of the securitisation more difficult for the investors to model and assess.

Question 7: Do you agree with the criteria on simplicity? Please provide comments on their technical applicability and relevance for synthetic securitisation.

5.4.3 Standardisation criteria

Criterion 14:	Risk retention requirements
Comparison with the criterion for traditional securitisation:	Article 21(1) Similar

Content of the criterion:

The originator or original lender should satisfy the risk-retention requirement in accordance with Article 6 of the Securitisation Regulation.

Rationale for the criterion:

See overarching consistency with the framework for traditional securitisation.

Although it is not necessary strictly to include this requirement in the STS criteria, given it is applicable to all securitisations as per Article 6 of the Securitisation Regulation, it is included here for consistency purposes.

Criterion 15:	Appropriate mitigation of interest rate and currency risks
Comparison with the criterion for traditional securitisation:	Article 21(2) Adapted to further specify measures for appropriate mitigation of interest rate and currency risks

Content of the criterion:

Currency risk: Currency risk arising in the synthetic securitisation should be appropriately mitigated and measures taken to that effect should be disclosed. *The protection buyer should bear no currency risk in relation to the credit protection it receives. This may be done in either of the following ways:*

- *the guarantee or derivative contract and, where applicable, the collateral securing the credit protection obligation should be denominated in the same currency as the underlying exposures, or*
- *through other appropriate arrangements, which ensure that the protection buyer does not bear any currency risk in relation to the credit protection it receives.*

Interest rate risk: Interest rate risk associated with the synthetic securitisation should be mitigated and measures taken to that effect should be disclosed. *The protection buyer should bear no interest rate risk in relation to the credit protection it receives. In the case of a synthetic securitisation involving an SSPE, the amount of the SSPE's liabilities in terms of interest payments to investors at any payment date should be equal to or less than the amount of its income from the protection buyer and any collateral arrangements at such payment date.*

The underlying exposures should not include derivatives, *other than derivatives entered into for currency or interest-rate hedging purposes in connection with the underlying exposures.*

Those derivatives should be underwritten and documented according to common standards in international finance.

Rationale for the criterion:

Unlike in the case of traditional securitisation, in synthetic securitisation the interest and principal cash flows generated by the underlying exposures are not used to repay investors. Payments towards synthetic securitisation investors are limited to the credit risk protection premium and, as applicable, the yield from the re-investment of the collateral used in funded transactions, and the redemption of such collateral, which will be used to repay noteholders at maturity or at early termination of the contract.

However the originator (protection buyer) of synthetic transactions may: (i) face instances of under-protection due to exchange rate fluctuations in transactions where more than one currency is involved; (ii) be exposed to interest rate mismatches, itself or through the SSPE set up to issue notes to investors, where it guarantees to investors a return on the collateral received as credit risk protection beyond the payment of the due credit protection premium.

Currency risk: In synthetic securitisation transactions where the underlying exposures are denominated in a different currency than the currency in which the credit protection is denominated (i.e. the transaction currency) the risk arises that, due to exchange rate fluctuations and depending on the reference exchange rate used for converting loss amounts into protection payment amounts, the outstanding amount of the notes / available collateral / committed guarantee amount after conversion into the currency in which the underlying exposures are denominated may be reduced resulting in a diminished protection in respect of the underlying exposures. Even though the CRR provides for additional capital requirements on the originator for transactions characterised by currency mismatches, it is important that the currency risk to which STS securitisation positions are exposed is appropriately mitigated. This can be done either through the credit protection being denominated in the same currency as the underlying exposures, or by other measures such as hedges and guarantees that can fix the currency rate for the protection buyer, or by other equivalent arrangements such as for example adapting the notional amount of the portfolio to manage exchange rate fluctuations through replenishment.

Interest rate risk: Interest rate risk should be appropriately mitigated. Additional criterion 36 provides for eligible credit risk protection arrangements. The exclusion of more complex collateral and re-investment arrangements in synthetic STS securitisations further reduces the extent to which of interest rate mismatches may occur in such securitisations.

Derivatives should be allowed as underlying exposures of a synthetic STS securitisation only where those derivatives are used for the single purpose of hedging the currency and interest rate risk arising from the underlying exposures that are not derivatives. For the sake of clarity, it should be highlighted that any derivative contract used to effect the credit risk transfer that gives rise to the synthetic securitisation is not to be considered an 'underlying' exposure of the synthetic securitisation.

Criterion 16:	Referenced interest payments
Comparison with the criterion for traditional securitisation:	Art. 21(3) Similar

Content of the criterion:

Any referenced interest payments under the securitisation assets and liabilities should be based on generally used market interest rates, or generally used sectoral rates reflective of the cost of funds, and should not reference complex formulae or derivatives.

Rationale for the criterion:

This criterion is less relevant for synthetics as the repayment of the securitisation positions is not dependent on the cash flows from the underlying exposures on a pass-through basis, and consequently there is less need for investors to understand the calculation of the interest payments on the underlying exposures. This information might however still be useful in particular with regard to public synthetic securitisations making use of an SSPE with various investors and the requirement should therefore be kept for consistency purposes.

Criterion 17:	Requirements after enforcement/acceleration notice
Comparison with the criterion for traditional securitisation:	Art. 21(4) Adapted to reflect that not all synthetic securitisations use SSPE

Content of the criterion:

Following the occurrence of an enforcement or acceleration event, the enforcement or acceleration should be initiated immediately and sequential amortisation should continue to apply to all tranches *so that, as the underlying exposures amortise, the outstanding amount of all tranches is reduced in order of their seniority.*

Where an SSPE is used within a synthetic securitisation, following an enforcement or acceleration notice no amount of cash should be trapped in the SSPE beyond what is necessary to ensure the operational functioning of the SSPE or the orderly repayment of investors in accordance with the contractual terms of the securitisation.

Rationale for the criterion:

It is appropriate that arrangements are in place for the protection of protection buyers in case of adverse circumstances affecting the SSPEs or, where applicable, the collateral (such as, insolvency of SSPE or inaccessibility of collateral), which has a consequence of immediately initiating the enforcement/acceleration and applying sequential amortisation to all tranches of the synthetic securitisation.

The requirements applicable when enforcement/acceleration has been delivered have been adapted compared to the STS requirements applicable for traditional securitisation, to reflect that not all synthetic securitisation include the use of an SSPE and that even in case of the use of an SSPE in balance sheet synthetic securitisations there is no legal transfer of title to the underlying exposures to the SSPE. Due to the latter, a requirement that does not allow the automatic liquidation of the underlying exposures at market value is not needed for synthetic securitisations.

Criterion 18:	Allocation of losses and amortisation of tranches
Comparison with the criterion for traditional securitisation:	Art. 21(5) Adapted with additional requirements for pro rata amortisation and allocation of losses requirements

Content of the criterion:

Allocation of losses: *The allocation of losses to holders of a securitisation position in a synthetic STS securitisation should always proceed in order of seniority of tranches, from the most junior tranche to the most senior tranche in the transaction.*

Amortisation of size of tranches: Pro-rata amortisation may only be applied to determine the outstanding amount of all tranches where clearly specified triggers relating to the performance of the underlying exposures ensure the switch of the amortisation scheme 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.

Where this is not the case, sequential amortisation should apply to all tranches in order to determine the outstanding amount of the tranches at the respective payment dates i.e. as the underlying exposures amortise, such amortisation should be applied first to reduce the most senior tranches and only once these most senior tranches have fully amortised to reduce more junior tranches in accordance with the order of seniority as agreed in the transaction documentation.

As tranches amortise, where investors have provided collateral for tranches as part of the credit protection agreement establishing the synthetic securitisation, a collateral equal to the amount of amortisation on such tranches should be returned to investors. In case of underlying exposures in relation to which a credit event has occurred and the workout process has not been completed, the sequential amortisation scheme should ensure the total outstanding amount of all tranches at any payment date is at least equivalent to the notional outstanding amount of such underlying exposures after consideration of the amount of any interim payment that have already been effected on such underlying exposure in relation to the respective credit event.

All amortisation agreements, applicable before and after the occurrence of an enforcement or acceleration notice, should be clearly documented.

Rationale for the criterion:

See overarching rationale for consistency with traditional qualifying framework.

From a prudential perspective, pro-rata amortisation schemes in the presence of back-loaded losses, i.e. losses that crystallise towards the end of the underlying exposures' tenor, may undermine the simplicity and standardisation of the transaction. Other things being equal, in the presence of pro-rata amortisation the originator is only able to rely on a level of credit protection that, towards the end of the tenor of the transaction, is materially lower than the one it could rely on when a sequential amortisation scheme is adopted. Therefore, pro-rata amortisation should be allowed only under limited circumstances i.e. subject to specific contractual triggers, which require a switch to sequential amortisation.

In order to ensure that all parties involved in the synthetic securitisation have at all times a thorough understanding of applicable amortisation schemes under a securitisation, such amortisation schemes should be clearly specified in the transaction documentation.

Criterion 19:	Early amortisation provisions/triggers for termination of the revolving period
Comparison with the criterion for traditional securitisation:	21(6) Adapted with requirements for early amortisation only in the case of the use of an SSPE

Content of the criterion:

The transaction documentation should include appropriate triggers for termination of the revolving period where the securitisation is a revolving securitisation, or early amortisation provisions *where an SSPE is used within a synthetic securitisation to issue notes placed with investors*, including at least the following:

- A deterioration in the credit quality of the underlying exposures to or below a predetermined threshold;
- *Losses rise above a predetermined threshold, or losses over a predefined period rise above a predetermined threshold;*
- A failure to generate sufficient new underlying exposures that meet the predetermined credit quality.

Rationale for the criterion:

It is important to include safeguards for investors when the securitisation is a revolving securitisation, to ensure that subject to specific triggers the replenishment period truncates and the tranches start to amortise. This criterion is generally relevant for synthetic securitisations, as the use of replenishment periods is very common in synthetic securitisations. The triggers have been adapted to synthetic securitisation.

By contrast, early amortisation is about earlier repayment of principal, and is therefore only relevant for synthetic securitisations using an SSPE to place notes with investors.

This criterion is linked with the requirement for the credit protection payments (that should be contingent upon the outstanding balance of the protected tranche).

Criterion 20:	Transaction documentation
Comparison with the criterion for traditional securitisation:	Art. 21(7) Adapted with additional requirements for servicing standards and procedures

Content of the criterion:

The transaction documentation should clearly specify:

- the contractual obligations, duties and responsibilities of, as applicable, *the verification agent*, the servicer, the trustee i.e. an ‘identified person’ with fiduciary responsibilities who acts in the best interest of investors in the securitisation transaction, and other ancillary service providers;
- upon default, insolvency and other specified events, where applicable, provisions to ensure the replacement of relevant counterparties (other than the protection buyer and the investors) for in cases where the respective services for the benefit of the securitisation are not provided by the originator itself;
- the processes and responsibilities necessary to ensure that, where servicing is not provided by the originator itself, the default or insolvency of the current servicer does not result in a termination of servicing, such as contractual provisions which enable the replacement of the servicer in such cases;
- *the servicing procedures that apply to the underlying exposures at the closing date and thereafter and the circumstances under which these procedures may be modified;*
- *the servicing standards the servicer will have to adhere to in servicing the underlying exposures within the entire maturity of the synthetic securitisation.*

Rationale for the criterion:

See overarching rationale for consistency with traditional qualifying framework.

Particularly where the credit risk of the securitised portfolio is transferred to more than one investor (e.g. where CLNs of different seniority are issued by an SSPE), the appointment of an identified person with fiduciary responsibilities acting in the best interest of investors is necessary in order to minimise the impact of potential conflicts in terms of the interpretation of certain provisions of the securitisation documentation and their applicability at payment dates.

From a perspective of an investor in synthetic securitisation it is also important that, irrespective of whether the underlying exposures are serviced by the originator or by another party, at closing data and thereafter the servicer adheres to high servicing standards in order to ensure that credit

events covered by the credit protection agreement and corresponding losses are determined correctly at the respective payment dates.

Criterion 21:	Servicer's expertise
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Comparison with the criterion for traditional securitisation:	21(8) Similar
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Content of the criterion:

The servicer should have expertise in servicing exposures of a similar nature to those securitised, supported by a management team with extensive industry experience.

The servicer should have well-documented and adequate policies, procedures and risk-management controls relating to the servicing of exposures.

The servicer should apply servicing procedures to the underlying exposures that are at least as stringent as the servicing procedures applied by the originator for similar exposures, which are not securitised.

Rationale for the criterion:

See also overarching rationale for consistency with traditional qualifying framework.

Effective servicing standards are crucial in any synthetic securitisation, as the validity of the credit protection obtained heavily depends on the timely identification of relevant credit events protected under the credit protection agreement. Losses that are not identified at the time of their occurrence, due to servicing disruptions, may not be eligible for credit protection. Such risk increases the overall riskiness of the originator's retained senior position. This appears to be particularly relevant in those cases where servicing is not carried out by the originator of the transaction.

Consistency and clarity of servicing standards, and sufficient experience with applying such standards, significantly reduce the extent of risks arising in relation to the servicing. In addition, STS synthetic securitisations should not be used to put in place any 'originate to distribute' behaviour through moral hazard practices arising in the servicing of exposures subject to protection.

Criterion 22:	Reference register
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Comparison with the criterion for traditional securitisation:	Art. 21(9) Replacement of the criterion (requirements for the transaction documentation to specify payment conditions is covered in separate criteria)
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Content of the criterion:

*The underlying exposures should be identified at all times via a **reference register**. The reference register should clearly identify, at all times, the reference obligors, the reference obligations from which the underlying exposures arise, the outstanding notional amount of each underlying exposure, and the protected notional amount for each underlying exposure.*

Rationale for the criterion:

To avoid conflicts between the protection buyer and the protection sellers and to ensure legal certainty in terms of the scope of the credit protection purchased for underlying exposures, such credit protection should reference clearly identified reference obligations, giving rise to the underlying exposures, of clearly identified entities or obligors. Therefore, the reference obligations on which protection is purchased should be clearly identified at all times, via a reference register, and kept continuously up to date. This requirement is also indirectly part of the criterion defining the balance sheet securitisation and excluding arbitrage securitisation from STS framework.

Criterion 23:	Timely resolution of conflicts between investors
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Comparison with the criterion for traditional securitisation:	21(10) Similar
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Content of the criterion:

The transaction documentation should include clear provisions that facilitate the timely resolution of conflicts between different classes of investors. *Where an SSPE is used within a synthetic securitisation to issue notes placed with investors*, voting rights should be clearly defined and allocated to noteholders and the responsibilities of the trustee and other entities with fiduciary duties to investors should be clearly identified.

Rationale for the criterion:

See overarching rationale for consistency with traditional qualifying framework.

This requirement aims to quickly resolve any potential conflicts between investors, as an additional safeguard to appointment of a verification agent - particularly where the credit risk of the securitised portfolio is transferred to more than one investor (e.g. where CLNs of different seniority are issued by an SSPE), the appointment of a trustee or other entity with fiduciary duties to investors appears necessary.

Question 8: Do you agree with the criteria on standardisation? Please provide comments on their technical applicability and relevance for synthetic securitisation.

5.4.4 Transparency criteria

Criterion 24:	Data on historical default and loss performance
Comparison with the criterion for traditional securitisation:	22(1) Similar

Content of the criterion:

The originator should make available data on static and dynamic historical default and loss performance, such as delinquency and default data, for substantially similar exposures to those being securitised, and the sources of those data and the basis for claiming similarity, to potential investors *before pricing*. Those data should cover a period of at least five years.

Rationale for the criterion:

See overarching rationale for consistency with traditional qualifying framework.

As the first criterion on simplicity requires that the protection buyer under the credit protection arrangements is an originator with respect to the securitised exposures and according to the sponsor definition pursuant to Article 2(5) of the Securitisation Regulation only credit institutions or investment firms other than the originator can qualify as a sponsor, the obligation in terms of making data available has been limited to the originator for synthetic securitisation.

Criterion 25:	External verification of the sample
Comparison with the criterion for traditional securitisation:	22(2) Similar

Content of the criterion:

A sample of the underlying exposures should be subject to external verification *prior to closing* by an appropriate and independent party, *including verification that the underlying exposures meet the criteria determining eligibility for the credit protection under the credit protection agreement*.

Rationale for the criterion:

In synthetic securitisation compliance with contractual eligibility criteria determine the validity and therefore the effectiveness of the credit protection. From a transparency perspective it is crucial to ensure that any potential for disputes over the validity of the credit protection is minimised during the life of the transaction. For this reason, in the case of synthetic securitisation the audit prior to issuance should specifically cover eligibility conditions and should be carried out with a confidence level of at least 99%.

Criterion 26:	Liability cash flow model
Comparison with the criterion for traditional securitisation:	22(3) Similar

Content of the criterion:

The originator should, before the pricing of the securitisation, make available to potential investors a liability cash flow model which precisely represents the contractual relationship between the underlying exposures and the payments flowing between the originator, investors, other third parties and, where applicable, the SSPE, and should, after pricing, make that model available to investors on an ongoing basis and to potential investors upon request.

Rationale for the criterion:

To ensure consistency with the traditional framework, and to enhance transparency, the requirement to make available a liability cash flow model to investors is being maintained for synthetic STS securitisation.

Criterion 27:	Environmental performance of assets
Comparison with the criterion for traditional securitisation:	Art. 22(4) Similar

Content of the criterion:

In the case of a securitisation where the underlying exposures are residential loans or auto loans or leases, the originator should publish the available information related to the environmental performance of the assets financed by such residential loans or auto loans or leases, as part of the information disclosed pursuant to point (a) of the first subparagraph of Article 7(1) of the Securitisation Regulation.

Rationale for the criterion:

See overarching rationale for consistency with traditional qualifying framework.

Criterion 28:	Compliance with transparency requirements
Comparison with the criterion for traditional securitisation:	Art. 22(5) Similar

Content of the criterion:

The originator should be responsible for compliance with Article 7 of the Securitisation Regulation. The information required by point (a) of the first subparagraph of Article 7(1) should be made available to potential investors before pricing upon request. The information required by points (b) to (d) of the first subparagraph of Article 7(1) should be made available before

pricing at least in draft or initial form. The final documentation should be made available to investors at the latest 15 days after closing of the transaction.

Rationale for the criterion:

See overarching rationale for consistency with traditional qualifying framework.

Question 9: Do you agree with the criteria on transparency? Please provide comments on their technical applicability and relevance for synthetic securitisation.

5.4.5 Criteria specific to synthetic securitisation

Criterion 29:	Credit events
Comparison with the criterion for traditional securitisation:	N/A

Content of the criterion:

The credit protection agreement establishing the synthetic securitisation should cover, **at least, the following credit events:**

- Failure to pay of the underlying obligor, defined to encompass at a minimum the circumstances defined in Article 178 (1)(b) of the CRR;
- Bankruptcy of the underlying obligor, defined to encompass at a minimum the circumstances defined in Article 178 (3)(e) and (f) of the CRR;
- Restructuring of the underlying exposure, defined to encompass at a minimum the circumstances defined in Article 178(3) (d) of the CRR.

The requirement to include at least these three events should not prevent the parties from agreeing on additional and/or stricter credit events. All credit events that are to apply, and their precise definitions, should be **clearly documented**.

Forbearance measures, as defined in Annex V Section 30 paragraphs 163 to 183 of Commission Implementing Regulation (EU) 2015/227 amending Implementing Regulation (EU) No 680/2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013, applied to underlying exposures shall not preclude the trigger of eligible credit events.

Rationale for the criterion:

The definitions of credit events provided in the CRR shape the way prudential regulation quantifies the credit risk to be covered by regulatory capital and such well-established definitions should also be applied as a basis for standardising the minimum credit events to be considered in synthetic STS securitisations. A reference to the CRR definitions also strikes a right balance between the interest of the protection buyer and the interest of investors.

The parties under the credit protection agreement may agree on additional events or stricter definitions of the events mentioned in the criterion (e.g. failure to pay with a grace period of less than 90 days), in line with the general framework provided for in the standard industry master agreements, as long as that the credit protection agreement complies with the requirements provided for Article 249 of the amended CRR and, at a minimum, the events taken into account for prudential purposes for institutions regulated under the CRR are included in the credit protection agreements.

Forbearance measures, which consist of concessions towards a debtor that is experiencing or about to experience difficulties in meeting its financial commitments, should not preclude the triggering of the credit protection event. In this regard, concessions refers to either a

modification of the previous terms and conditions of a contract that the debtor is considered unable to comply with due to its financial difficulties ('troubled debt') resulting in insufficient debt service ability and that would not have been granted had the debtor not been experiencing financial difficulties; or a total or partial refinancing of a troubled debt contract, that would not have been granted had the debtor not been experiencing financial difficulties. A concession may entail a loss for the lender, which should be considered within the credit protection agreement.

Criterion 30:	Credit protection payments
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Comparison with the criterion for traditional securitisation:	N/A
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Content of the criterion:

The credit protection payment following the occurrence of a credit event should be calculated based on the **actual realised loss** suffered by the originator, as worked out in accordance with its standard recovery policies and procedures for the relevant exposure types¹⁴ and as recorded by the originator in its financial statements at the time the payment is made.

The final credit protection payment should be payable within a specified period following the end of the workout process for the relevant underlying exposure.

Transactions should provide that an **interim credit protection payment** is to be made, at the latest, 6 months after the credit event has occurred in cases, where the workout of the losses for the relevant underlying exposure has not been finalised by that time.

The interim credit protection payment should be, at least, the maximum of the impairment considered by the originator in its financial statements, in accordance with the applicable accounting framework, at the time the interim payment is made and, if applicable, the LGD determined in accordance with Part Three Title II Chapter 3 CRR that has to be applied to the corresponding underlying exposures in order to determine the IRB capital requirements on the originator for such underlying exposure according to the CRR. Where an interim credit protection payment is made, a final credit protection payment should be made in order to adjust the interim settlement of losses to the actual realised loss, in accordance with the first paragraph of this criterion.

Where the protected amount is less than the outstanding notional amount of the corresponding underlying exposure, the credit protection payment should be in the same proportion to the protected amount as the protection buyer's realised loss bears the outstanding notional amount of the underlying exposure, subject only to the rule on interim payments.

The method by which interim and final credit protection payments are calculated should be clearly specified in the credit protection agreement.

¹⁴ "Exposure type" is used here to distinguish from "type of exposure" as defined for IRB purposes according to Art. 142(1)(2) CRR.

The rights of the protection buyer to receive protection payments under the synthetic securitisation should be enforceable.

The amounts payable by investors under the securitisation are clearly defined, capable of calculation in all circumstances and limited in amount.

The circumstances in which investors are required to make payments under the credit protection agreement should be clearly defined objective or subject to a determination by the verification agent, and limited in number.

The credit protection amount should be broken down to the level of individual underlying exposures.

Rationale for the criterion:

From the originator's perspective, in order to ensure that the credit protection eventually covers the losses incurred by the originator, it is important that loss settlements do not fall short of the loss amounts as worked out by the originator. In addition, aligning credit protection payments to the loss amounts worked out by the originator ensures that the protection buyer's and the protection seller's interests in the transaction are more aligned, leading to better incentives on both sides of the transaction.

As the full work out of losses can be a lengthy process, depending on the type of asset class/collateral under consideration as well as the characteristics of national judicial and insolvency regimes, it is important from the originator's perspective to ensure a minimum degree of timeliness in credit protection payments in all circumstances. For this reason, and also to ensure that the originator does not keep paying for credit protection on the protected notional amount of a given underlying exposure when a credit event has occurred in relation to that exposure, an interim payment should be made at the latest 6 months after such credit event has occurred. By means of a final adjustment payment, the payment to cover losses under the credit protection agreement in relation to a particular underlying exposures should then be adjusted to the fully worked-out loss amounts in order to ensure the coverage of actual losses through the credit protection.

Where an originator uses the IRB Approach for the purposes of determining its capital requirements for an underlying exposures, the interim payment should reflect, at least, the originator's LGD assigned to the underlying exposure (regulatory LGD or own estimate). Where the institution decides to recognise in its financial statements a higher figure than the LGD used for capital requirements purposes, it is important that the interim payment reflects such a decision.

In order to facilitate the loss allocation in case of the occurrence of credit events, the credit protection coverage should be broken down to the level of individual underlying exposures, irrespective of whether the credit protection amount is specified with reference to the individual underlying exposures or to the obligors in respect of those exposures.

Criterion 31:

Credit protection payments following the close out/final settlement at the final legal maturity of the credit protection agreement

Comparison with the criterion for traditional securitisation:

N/A

Content of the criterion:

With regard to underlying exposures for which a credit event has occurred and the workout process has not been completed 2 years after the scheduled legal maturity or early unwinding of a transaction (the final reference date), a final credit protection payment should be made on the basis of the actual loss suffered by the originator and recorded by the originator in its financial statements at that time.

Following any termination of the credit protection by investors, the workout process should continue in respect of any outstanding credit events, which occurred prior to such termination in the same way as described in the first paragraph.

Rationale for the criterion:

As the full work out of losses can be a lengthy process, depending on the type of asset class/collateral under consideration as well as the characteristics of national judicial and insolvency regimes, It is important from the originator's perspective to ensure a minimum degree of timeliness in credit protection payments. This not only increases certainty in the effectiveness of the credit protection arrangement from the originator's perspective, but also increases legal certainty in terms of the final date of payments under the credit protection agreement from an investor's perspective, contributing to a well-functioning market.

Criterion 32:

Credit protection premiums

Comparison with the criterion for traditional securitisation:

N/A

Comparison with other sources:**Content of the criterion:**

The credit protection premiums paid under the credit protection agreement establishing the synthetic securitisation should be structured as contingent premiums: no guaranteed premiums, upfront premium payments, rebate mechanisms or other mechanisms that may avoid or reduce the actual allocation of losses to the investors or return part of the paid premiums to the originator after the maturity of the transaction, should be stipulated in the credit protection agreement.

The documentation should contain all relevant information that has been used to price the credit protection agreement, including, as applicable, information on the market benchmarks and other market variables taken into account, by the originator, for the pricing.

Rationale for the criterion:

For the sake of simplicity of the transaction and effectiveness of the risk transfer, the credit protection premiums should be contingent i.e. the actual amount of premium paid should be a function of the size and the credit risk of the protected tranche. Contingent premiums may be structured as a fixed percentage of the residual outstanding balance of the protected tranche at each payment date, hence reflecting tranche amortisation and tranche write-downs due to incurred losses.

Non-contingent premiums should not be allowed in synthetic STS securitisations i.e. when the actual amount of premium paid is not a function of the outstanding size and credit risk of the protected tranche. Non-contingent premiums may take the form of guaranteed premiums.

The timing of the premium payments may also vary across transactions. In some transactions protection premiums are paid up front, in contrast with the most widespread market practice according to which protection premiums are paid in accordance with a regular schedule. Transactions may also be structured to include protection premium rebate mechanisms, whereby if at the maturity of the protection period the aggregate premium paid by the protection buyer exceeds losses suffered on the reference portfolio, the excess would be returned to the originator. In order to ensure that synthetic STS securitisations are simple and that the risk assessment of such securitisations is not overly complex, these premium structures should not be allowed.

Criterion 33:	Verification agent
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Comparison with the criterion for traditional securitisation:	N/A
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Content of the criterion:

A third party verification agent should be appointed by the originator at the outset of the transaction, in order to verify, at a minimum, the following points for each of the underlying exposures in relation to which a credit event notice was given:

- that the credit event in the credit event notice occurred in accordance with terms of the credit protection agreement;
 - that the underlying exposure was included in the securitisation at the time of the occurrence of the relevant credit event;
 - that the underlying exposure met the eligibility criteria, at the time of inclusion in the reference portfolio;
 - that where an underlying exposure has been added as result of a replenishment, such replenishment complied with the replenishment conditions;
 - the accuracy of the final loss amount work out procedure, also in relation to the losses registered in the profit and loss statement by the originator;
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- that at the time where the final protection payment is made, the allocation of losses to investors in relation to the underlying exposures has been conducted correctly.

The verification agent should be independent of the originator and, where an SSPE is used within a synthetic securitisation, of the SSPE and should have been appointed, and its appointment accepted, on or before the closing date.

Such verification by the verification agent may be performed on a sample basis rather than for each individual underlying exposure for which a protection payment is sought but in all cases, any investor must have the right that the eligibility of a particular underlying exposures is subject to verification including in case if it is not satisfied with the sample verification.

The originator should undertake in the securitisation documentation that it should provide to the verification agent all the necessary information to verify the requirements set out in the first paragraph.

Rationale for the criterion:

The appointment of a verification agent is a widespread market practice that enhances legal certainty in the transaction for all parties involved, thus decreasing the likelihood of disputes and litigations that could arise in relation to the loss allocation process. This contributes to decreasing the overall riskiness of both retained securitisation positions and securitisation positions placed with investors and is instrumental to a well-functioning of a transaction.

Criterion 34:	Early termination events
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Comparison with the criterion for traditional securitisation:	N/A
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Content of the criterion:

Other than as a result of insolvency of the protection provider, or a failure to pay (in respect of any premium or other amounts payable by the originator to investors under the synthetic securitisation), or breach of a material contractual obligation by the protection provider, the originator should only be permitted to terminate a transaction prior to its scheduled maturity when either of the following occurs:

- relevant regulatory events which should:
 - include changes in all relevant law and/or regulation (or official interpretation of that law and/or regulation by competent authorities) directly affecting the contractual relationship defining the transaction and/or materially affecting the allocation of benefits among the parties of the transaction. In this regard, relevant law/regulation should include relevant taxation and accounting provisions.
 - exclude other factors affecting the economic efficiency of the transaction that are not enshrined in law or regulation, such as credit rating agencies' methodologies or a central bank's collateral framework.
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- a time call is exercised, at a point in time, where the time period measured from the securitisation's closing date is equal to or higher than the weighted average life of the initial reference portfolio at closing]. The time call should not be structured to avoid allocating losses to credit enhancement positions or other positions held by investors and should not be otherwise structured to provide credit enhancement.
- a call as per Article 245(4)(f) of the amended CRR is exercised [clean-up call].

If any of these call rights are included in a transaction, they should be clearly specified in the documentation.

Any other originator calls should not be allowed under the terms of the synthetic transaction.

Rationale for the criterion:

Synthetic STS securitisations should not feature complex *call* clauses for the originator. Whereas the merit of time calls is acknowledged from the originator's perspective, in particular to ensure that the economic sustainability of a transaction is accounted for, originators should not use synthetic securitisation transactions with very short-dated time calls with the aim of temporarily changing the representation of their capital position on an ad-hoc basis.

The originator's bankruptcy as an additional clause of early termination in synthetic transactions is reported as widespread market practice of the synthetic securitisation market. It should be seen from two perspectives:

- Investor (protection provider) perspective: the originator's bankruptcy exposes the investor to the following risks: (i) subordination vis-à-vis other creditors of the insolvent originator, (ii) deterioration of the originator's servicing standards/incentives during the bankruptcy phase. The early termination clause allows investors to mitigate these risks as the originator's bankruptcy occurs, thus maintaining an incentive for the protection provider to participate in such market;
- Originator (protection buyer) perspective: with respect to the originator's bankruptcy, in case of termination of the credit protection agreement in a scenario of originator's bankruptcy, the originator's insolvency estate may not rely on credit protection on the securitised portfolio and is faced with reduced regulatory capital resources against the portfolio under consideration due to the previous achievement of significant risk transfer (SRT) and consequent capital relief since origination. In this respect the recovery prospects of the originator's other insolvency creditors are at stake as the credit protection contract is terminated upon the event of bankruptcy. The originator's bankruptcy should therefore not be permitted as early termination event.

Taking into consideration the above, the bankruptcy of the originator should not be allowed as an early termination event for the STS synthetic securitisation.

It is however also to be noted that with the introduction of the BRRD, as an alternative to liquidation, originators may be subject to resolution measures. The BRRD foresees that, as originators enter resolution, structured finance transactions and other specific classes of

arrangements are subject to specific provisions safeguarding the transactions' counterparties, in the context of partial property transfers and other resolution measures. In these cases contractual clauses such as termination upon originator's bankruptcy may be dis-applied and the rights and interests of the counterparties in the transaction would be dealt with by BRRD-specific measures and tools (It should be noted that a number of (small) firms are likely to be excluded from such BRRD provisions).

Criterion 35:	Synthetic excess spread
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Comparison with the criterion for traditional securitisation:	N/A
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Content of the criterion:

The protection buyer should not commit to any amount of excess spread available for the investors.

Rationale for the criterion:

The excess spread, although widely present in synthetic securitisation transactions, is a complex structural feature and a commitment to excess spread available for the investors should therefore not be included in the STS securitisation. The complexity arises with respect to the quantum of committed excess spread, and its calculation and allocation mechanism. For the sake of simplicity and standardisation of STS synthetic securitisation, it should therefore not be allowed to commit any fixed amount of excess spread.

Criterion 36:	Eligible credit protection agreement, counterparties and collateral
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Comparison with the criterion for traditional securitisation:	N/A
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Content of the criterion:

Only the following credit protection arrangements establishing the synthetic securitisation should be allowed:

- A. a guarantee meeting the requirements set out in Chapter 4 of Part Three Title II of the CRR, by which the credit risk is transferred to any of the entities listed under Article 214 (2) (a) to (d) of the CRR, provided that the exposures to the protection provider qualify for a 0% risk weight under Chapter Two of Part Three Title II of the CRR, or;
- B. a guarantee meeting the requirements set out in Chapter 4 of Part Three Title II of the CRR which benefits from a counter-guarantee of any of the entities referred to in point (i); or

- C. other credit protection in the form of guarantees or credit derivatives not referred to under the previous two points that is meeting the requirements set out in Sub-Section 2 of Section 3, Chapter 4 of Part Three Title II of the CRR as amended by Article 249 of the CRR, provided that the obligations of the protection seller are subject to the following collateral requirements.

When the collateral is provided in accordance with the point C, both the originator and the protection seller need to have recourse to high quality collateral, in either of the following forms:

- collateral is in the form of 0% risk weighted debt securities, held in a trust or entity set up for the sole purpose of holding securities whose notional value takes into account clearly determined and conservative haircuts to appropriately mitigate market and other risks, and which have a short remaining maturity of maximum 3 months, and under robust custody arrangements, or
- collateral in the form of cash held with a third party credit institution with a sufficient credit quality standing.

In addition, the following requirements should apply to the collateral:

- The rights of the originator to use the collateral to meet protection payment obligations of the investors should be enforceable. Security arrangements should be provided to ensure such right of the protection buyer.
- The rights of the investors when the synthetic securitisation is no longer outstanding to the return of any collateral that has not been used to meet protection payments should be enforceable.
- Where collateral is invested in securities, the securitisation documentation should set out the eligibility criteria and custody arrangement for such securities.

Where the investors remain exposed to the credit risk of the originator, this must be clearly disclosed in the securitisation documentation.

The originator should obtain an opinion from a qualified legal counsel confirming the enforceability of the credit protection in all relevant jurisdictions.

Rationale for the criterion:

Unlike in the case of traditional (true sale) securitisation, in synthetic securitisation transactions the actual extent of credit risk transfer also depends on:

- The risk of default of the protection provider, in case of unfunded credit risk mitigation arrangements, or;
 - The risk that the protection buyer may not have access to the collateral in a timely fashion and/or without incurring losses on the value of that collateral, in case of funded protection.
-

It is important that synthetic transactions eliminate or adequately minimise the counterparty credit risk incurred by the originator, to adequately mimic comparable traditional securitisation positions where such risk does not arise.

In the case of unfunded credit risk protection arrangements, this is ensured by restricting the scope of eligible protection providers to those entities that are eligible providers in accordance with the CRR and that the CRR recognises as counterparties to be risk-weighted at 0% in accordance with the Standardised Approach for credit risk.

Where the counterparty is not recognised by the CRR to be eligible for a 0% risk weight, the resulting counterparty credit risk can be mitigated by requiring the counterparty to fund the credit protection by providing high quality collateral (which in case of synthetic securitisation making use of an SSPE may include the issuance of credit linked notes). In order to mitigate the counterparty credit risk for both the originator and the protection seller, such high quality collateral should be held with a third party (such as in form of EU government securities or supranational entities held in a trust or a similar entity, or in form of cash held with a third party credit institutions).

In addition, a legal opinion should be provided to the originator to confirm that the credit protection is enforceable in all relevant jurisdictions. This requirement already exist under the CRR (Art. 245(4)(g)), and to ensure level playing field it should be applicable to all eligible originators under the STS synthetic framework.

Question 10: Do you agree with the specific criteria for synthetic securitisation?

Question 11: Do you agree with the criterion 36 on eligible credit protection agreement, counterparties and collateral? Please provide any relevant information on the type of credit protection and different collateral arrangements used in market practice and their pros and cons for the protection of the originator and investor.

Question 12: Please provide suggestions for any other specific criteria that should be introduced as part of the STS framework for simple, transparent and standardised securitisation.

5.5 Framework for a differentiated regulatory treatment of STS synthetic securitisation

5.5.1 The rationale underlying the approach to the regulatory treatment

102. The analysis in the previous sections suggests that the developments in the last few years have provided a foundation for the future growth of the synthetic sector and confirms a technical feasibility of creation of prudentially sound STS synthetic securitisation product comparable to the STS traditional securitisation product. It also endorses a solid rationale for the development of such product, accompanied by a limited and clearly defined differentiated regulatory treatment, under the two-stage approach as applied to the traditional securitisation.

103. On the one hand, introduction of a limited and clearly defined differentiated regulatory treatment, would therefore match the historical performance of the synthetic securitisation which outperforms the traditional securitisation, and would also be in line with the synthetic market specific characteristics and developments since the financial crisis. It would also ensure level playing field perspective with the STS traditional securitisation framework (currently eligible for differentiated regulatory treatment), and would help overcome constraints of current limited STS risk weight treatment for SME synthetics under Article 270 of the amended CRR.

104. On the other hand, one of the main deficiencies is that the preferential regulatory treatment would not be Basel compliant and there is a very limited experience with the STS traditional framework so far. Also, limitations of the performance data on which the analysis in this Discussion Paper is based, should be taken into account.

Technical feasibility of the creation of the STS synthetic securitisation product.

105. The analysis suggests that the structure of the synthetic securitisation allows to replicate that of traditional securitisation, including the STS traditional securitisation, in terms of mitigating the main drivers of risk such as agency and model risks that are not linked to underlying exposures. As a result, it allows to align the performances of synthetic securitisation with those of traditional securitisation of the same asset class.

Solid rationale for the STS synthetic securitisation product

106. There appears to be a good rationale for the development of the STS synthetic securitisation product. There seem to be no convincing strong reasons against development of STS product. There are not any material negative consequences while on the other hand there are a number of positive benefits for the banks, financial market and financial stability in general, of introduction of such a product.

Market characteristics, trends and developments

107. The analysis included in this report contains a number of arguments which support the rationale, and increases the relevance of the introduction of the STS synthetic securitisation:

- a. Size of the market: the data confirm the balance sheet synthetic market is enjoying 'renaissance', and volume and number of trades have been steadily increasing since the financial crisis.
- b. Bilateral/private type of transactions: as private/bilateral type of transactions nowadays form the substantial majority of synthetic market, the market is now more divergent and less standardised, including with respect to core structural features, compared to pre-crisis period where the deals were relatively standardised under the requirements of the credit rating agencies. This increases the importance of the standardisation of the market, including of the structural features, both for the market investors, and for competent authorities (and potentially for the third party certifiers) to help assess the quality of the product.
- c. Changing structure: following the crisis, originators have changed their involvement in the synthetic securitisation market to only place, to the extent possible, mezzanine/first loss tranches with investors. This reflects the change in motivation to engage in synthetics: regulatory capital management is no longer the sole motivation, and synthetic securitisation is also issued for credit risk and balance sheet management purposes under the current macro-economic and regulatory circumstances, allowing banks to hedge the tail risk and free up credit lines for further lending.
- d. Investor base: based on qualitative evidence gathered from the market, the introduction of STS synthetic product and its further standardisation would be extremely welcome by investors. On a separate account, given the limited activity of banks as investors, the regulatory capital treatment of synthetic securitisations by banks as securitisation investors does not seem to be key determinant of the demand for synthetic securitisation in the current market environment.
- e. Originators: the introduction of an STS product and its standardisation would enable to enlarge the originator base and open the market to smaller players. The analysed trends indicate that there is sound potential for growth of the synthetic market on the originator side. The relevance and attractiveness of synthetic securitisation as a credit risk and balance sheet management tool has also been rising especially due to recent regulatory developments, which enhance the needs for banks' capital, balance sheet and accounting management.
- f. Asset types: balance sheet synthetic securitisation has been crucial for the transfer of corporate credit risk from banks to markets and for strengthening the extension

of credit, especially to SMEs and large firms. Introduction of STS product would further extend the asset base, including to credit to retail customers.

- g. Geographical distribution of exposures: the majority of synthetic transactions contain exposures from different jurisdictions. Due to a specific nature of synthetic securitisation, it is inherently easier to execute on multi-jurisdictional portfolios and this represents an important comparative advantage vis-à-vis traditional securitisation. Given the synthetic securitisation is executed on different types of portfolio, the STS synthetic label would therefore not 'cannibalise' the STS traditional securitisation.

Good performance of the synthetic securitisation

108. The available performance data do not evidence worse performance of the synthetic securitisation instrument, compared to the traditional securitisation instrument. The available data confirm that the balance sheet synthetic transactions perform better than arbitrage deals, tend to outperform the performance of traditional securitisation, and are broadly consistent with the performance of comparable underlying exposures. From a consistency perspective, if the differentiated risk weight treatment is already assigned to synthetic securitisation of SME exposures under Art. 270 of the amended CRR, it could be considered to be extended to other asset classes.

109. The available data confirm the following:

- a. The arbitrage synthetics have performed materially worse than the balance sheet transactions.
- b. The balance sheet synthetics have performed better than traditional securitisations, for all asset classes (SMEs CLOs, RMBS, CMBS, and other CLOs).
- c. The same applies for all the rating grades. The default performance of balance sheet synthetics is better than that of the traditional securitisation, for all selected asset classes (all as of end 2018).
- d. In terms of rating transition (i.e. using the average number of notches of rating transition over the life of the tranche as a measure of average credit quality change incurred by the tranche), balance sheet synthetic tranches perform better than true sale tranches, with the exception of asset class of 'other CLOs'.
- e. There are zero default and loss rates on senior tranche, on a significant majority of reported transactions and asset classes. This is with the exception of SMEs, where the average annual default rate on 21 reported transactions is 0.11%, and annual loss rate is 0.02%.

- f. The default and loss rates are slightly higher when considering the whole portfolio (i.e. all tranches and not senior tranches only), but still very low (with respect to annual default rates, the value is in every case below 1%). The default and loss rates are highest for SMEs, and followed by specialised lending. Average annual default rate for SMEs is 0.59%, while maximum reported amount is 1.77%.
- g. Both default and loss rates are lower than those for comparable portfolios (comparable portfolios are defined in the sample as portfolios from the same business division, or using the same rating model as the securitized pool). This indicates that the originators systematically choose core exposures for the synthetic securitisation, with better default and loss performance than for comparable exposures held on the balance sheet, and do not 'cherry pick' exposures with bad performance.

Level playing field and consistency with the STS traditional framework

110. Introduction of differentiated regulatory treatment of STS synthetic securitisation would ensure a level playing field with similar treatment of the STS traditional securitisation. Similarly as in the case of traditional securitisation, regulatory recognition in the form of more sensitive regulatory treatment should be a natural implication of development of STS product which is simpler, more standardised and more transparent than other types of synthetic securitisation, as well as natural implication of the good historical performance of the synthetic securitisation which outpaces the performance of the traditional securitisation. The relevance of the regulatory recognition is underlined in particular in the context of the existing regulatory framework which increases the capital charges for securitisation positions compared to the previously existing framework.

Overcoming constraints of current limited STS risk weight treatment of SME synthetics

111. Art. 270 of the Securitisation Regulation already assigns preferential capital treatment to synthetic securitisation (senior tranches of SME securitisations held by originators). Also, the practicability of the provisions on STS treatment of synthetic securitisation of SME portfolios in Art. 270 of the CRR has proved to be limited. These provisions have been specifically designed for traditional securitisation and cannot/are difficult to be applied to synthetic product.

Fuelling the positive impact of the (STS) synthetic securitisation on the financial markets and stability

112. The regulatory recognition of the STS product, and expected increase in demand and issuance, is expected to further enhance the positive impacts of the synthetic securitisation. The banks' lending capacity may be increased, more capital may be able to be freed up indirectly for further lending to economy and more risk thus may be transferred to be spread from banks across the financial system.

Non-compliance with Basel

113. On the other hand, it should be noted that one of the main deficiencies of the STS framework for synthetics is that it would not be Basel compliant. The existing Basel STC framework only covers traditional securitisation and is not extended to synthetic securitisation. It is also unlikely that such framework – in particular the more risk sensitive regulatory treatment - will be developed in the future, taking into account that no consensus has been reached between Basel members. On the other hand, the deviations from Basel are not without precedence (for example, the EU extends more favorable treatment to covered bonds than Basel).

Data limitations

114. While the data used in the Discussion Paper cover a significant part of the synthetic market, their limitations should be duly taken into account (explained in more detail in section 5.2), in particular the fact that they may not be fully representative of the full market (for example, they cover only rated deals in S&P sample, and cover 70 transactions in IACPM sample), and may not necessarily cover the full cycle of the transactions (given a number of transactions covered in the data are have been issued in recent years).

Other considerations

115. It should also be considered that there is currently a lack of practical experience with the STS traditional securitisation framework which entered into force in January 2019 and had not yet been fully implemented. Before establishing any possible STS framework for synthetics, which may be considered too early at this stage, it may be argued that some experience should be gathered with the functioning of the STS traditional framework.

Question 13: Do you see a justification for possible introduction of a differentiated regulatory treatment of STS synthetic securitisation? If yes, what should be the scope of such treatment and how should it be structured - for example only for senior tranche retained by the originator bank, or more limited/wider?

Question 14: What would be the impact if no differentiated regulatory treatment is introduced? In that case, is the introduction of the STS product without preferential treatment relevant for the market?

Question 15: What would be the impact of potential differentiated regulatory treatment from level playing perspective with regard to third countries where STS framework has not been introduced?

Question 16: Should a separate explicit recommendation be included in the Recommendations section on whether or not such treatment should be introduced?

5.6 EBA Recommendations¹⁵

RECOMMENDATION 1:

The EBA recommends to establish a cross-sectoral framework for simple, transparent and standardised securitisation, limited to balance-sheet securitisation.

RECOMMENDATION 2:

The EBA recommends 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, as specified in Section 5.4.

¹⁵ Depending on the conclusions following the public consultation, the EBA may consider introduction of an additional recommendation on possible differentiated capital treatment.

Annex - Summary of questions

5.1 Introduction

Question 1: Do you have any comments on this introductory section of the Discussion Paper?

5.2 Market developments and trends

Question 2: Do you agree with the analysis on the market developments? Please provide any additional relevant information to complement the analysis.

Question 3: Do you agree with the analysis of the historical performance? Please provide any additional relevant information to complement the analysis.

5.3 Rationale

Question 4: Do you agree with the analysis of the rationale for the creation of the STS synthetic instrument? How useful and necessary is synthetic securitisation for the originator and the investor? What are the possible hurdles for further development of the market?

Question 5: Do you agree with the assessment of the reasons that could eventually support a preferential capital treatment?

Question 6: Please provide any additional relevant information on potential impact of the creation of the STS synthetic securitisation on (STS) traditional securitisation, and any other information to complement the analysis.

5.4 Criteria for STS synthetic securitisation

Question 7: Do you agree with the criteria on simplicity? Please provide comments on their technical applicability and relevance for synthetic securitisation.

Question 8: Do you agree with the criteria on standardisation? Please provide comments on their technical applicability and relevance for synthetic securitisation.

Question 9: Do you agree with the criteria on transparency? Please provide comments on their technical applicability and relevance for synthetic securitisation.

Question 10: Do you agree with the specific criteria for synthetic securitisation?

Question 11: Do you agree with the criterion 36 on eligible credit protection agreement, counterparties and collateral? Please provide any relevant information on the type of credit protection and different collateral arrangements used in market practice and their pros and cons for the protection of the originator and the investor.

Question 12: Please provide suggestions for any other specific criteria that should be introduced as part of the STS framework for simple, transparent and standardised securitisation.

5.5 Framework for a differentiated regulatory treatment of STS synthetic securitisation

Question 13: Do you see a justification for possible introduction of a differentiated regulatory treatment of STS synthetic securitisation? If yes, what should be the scope of such treatment and how should it be structured – for example only for senior tranche retained by the originator bank, or more limited/wider?

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Question 15: What would be the impact of potential differentiated regulatory treatment from level playing perspective with regard to third countries where STS framework has not been introduced?

Question 16: Should a separate explicit recommendation be included in the Recommendations section on whether or not such treatment should be introduced?