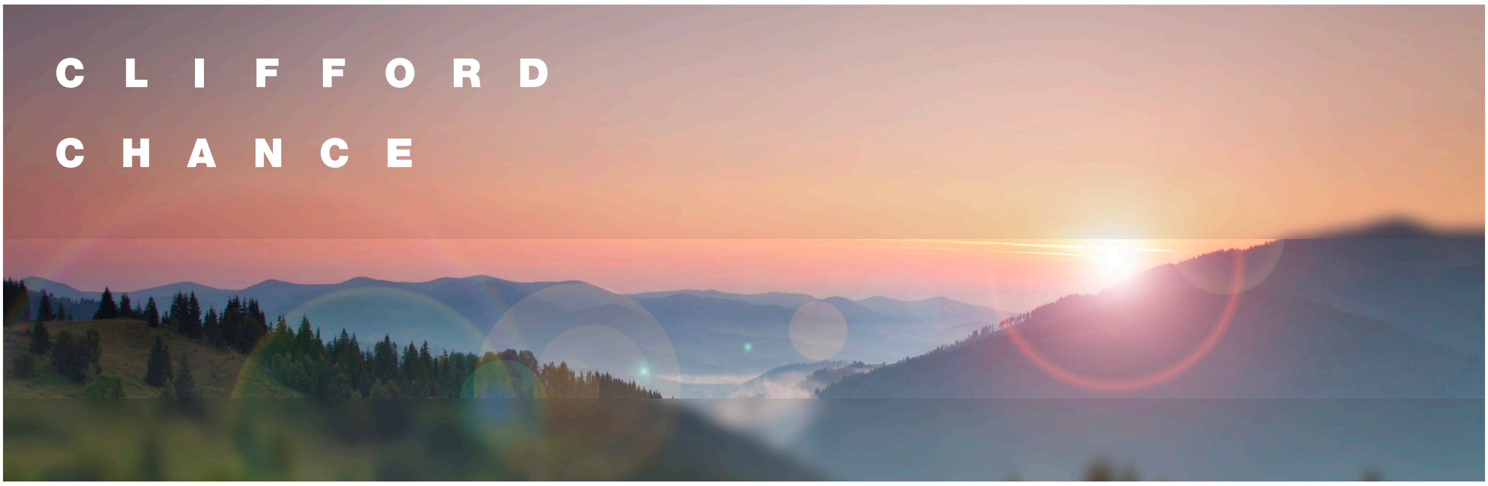

SYNTHETIC SECURITISATIONS AND SIGNIFICANT RISK TRANSFER

A key motivation for banks to execute synthetic securitisations is to reduce the amount of regulatory capital the bank is required to hold in respect of the underlying portfolio. Where the transaction satisfies the requirements for significant risk transfer under the Capital Requirements Regulation ("**CRR**"), the bank is able to substitute the pre-securitisation capital requirement for each underlying exposure with an aggregate capital calculation based on the securitised tranches. The requirement for each tranche will be based on the credit risk of that tranche, with the first loss tranche being viewed as high risk and the senior tranche receiving a significantly lower risk weight. By transferring the exposure to some or all of the riskiest tranches to investors, as is typically the case for synthetic securitisations, the reduction in regulatory capital for originators can be significant.

This article is part of a series that will be published in our "Structured Debt in a New World" publication launching early 2022. The publication will cover hot topics in the structured debt market such as this one.

Background

The existing provisions in relation to significant risk transfer are set out in Articles 244 and 245 of the CRR, and provide two different methods to achieve significant risk transfer: (i) the "mezzanine test", pursuant to which the originator retains not more than 50% of the risk-weighted exposure amounts of all mezzanine tranches in the securitisation, and (ii) the "first loss test", whereby the originator holds not more than 20% of the exposure value of the first loss tranche in the securitisation, subject to (A) the originator demonstrating that the exposure value of the first loss tranche exceeds a reasoned estimate of the expected loss on the underlying exposures by a substantial margin, and (B) there not being any mezzanine securitisation position. These are often referred to as the "mechanistic tests". In addition to the mechanistic tests, it is also necessary for the bank to show that the reduction in the risk-weighted exposure amounts which would be achieved by the securitisation is justified by a commensurate transfer of credit risk to the investors, and for the securitisation to comply with a number of other structural requirements.

However, the existing regime has been subject to market criticism for being insufficiently precise and prescriptive, with some elements (such as the commensurate risk transfer test) being vague and with little guidance on what constitutes mandatory versus permitted versus disqualifying features. As a result, competent authorities have been left with wide discretion and the unenviable task of interpreting the rules, which has led to varying approaches being taken across different European jurisdictions. These local interpretations have also shifted over time, compounding the uncertainty faced by originators. In a market which is inherently private, this has left many banks to rely on a patchwork of precedents, guidelines and market knowhow when attempting to predict how their transactions and key structural features will be treated.

The EBA Report

On 23 November 2020, the EBA published its much anticipated report on significant risk transfer in securitisation (the "**EBA Report**"). The EBA Report focusses on three main areas of significant risk transfer where inconsistencies were found, and in relation to which the EBA determined that greater harmonisation of both supervisory practices and structuring processes would markedly contribute to enhancing the efficiency and consistency of supervisory assessments within the current framework. These are: (i) structural features of securitisation transactions; (ii) significant risk transfer tests; and (iii) the significant risk transfer assessment process and standard documentation.

Among other things, the EBA Report attempts to plug some of the gaps in Article 245 of CRR by providing more detailed guidance to the relevant competent authorities as to how structural features should be assessed, with the aim of creating more consistency in the SRT securitisation market across different EU jurisdictions. It does so by (i) setting out certain structural features the inclusion of which would disqualify a transaction from achieving significant risk transfer, (ii) listing certain structural features which will require additional safeguards to be put in place in order for significant risk transfer to be recognised, and (iii) requiring originators to submit a quantitative analysis on the various structural features to the competent authority as part of its risk transfer assessment.

While this article does not seek to summarise all the recommendations made in the EBA report, of particular interest to synthetic securitisations are:

1. ***Pro rata* amortisation** – The EBA recommendations in relation to *pro rata* amortisation clarify what has to date been a somewhat murky area with inconsistent approaches taken by both banks and regulators. This includes deals with "*pro rata* for life", "*pro rata* switch to sequential" and "sequential only" transactions, all of which can currently be found in the market. The EBA suggests that *pro rata* amortisation should not of itself be a barrier to achieving significant risk transfer, however, certain backwards- and forward-looking triggers should be in place to switch the amortisation mechanics to sequential if the portfolio deteriorates or does not perform as well as expected at inception. From a structuring perspective, this will grant banks the flexibility to use *pro rata* where appropriate, and the triggers should give the regulators comfort that the junior tranches will not be over-amortised (and that the protection will remain in place) in stressed scenarios.
2. **Time calls** – The EBA recommends that time calls which satisfy the requirements set out in the report (which are broadly in line with the current use of time calls in synthetic securitisations), should not be seen as hindering the achievement of significant risk transfer. Time calls have, together with *pro rata* amortisation, been

seen as one of the main divisive features in the market, with some regulators declining to approve transactions with time calls, or requiring the bank to treat the earliest call date as the scheduled maturity of the securitisation, with the resulting maturity mismatch causing the transaction to be economically unviable. A uniform approach to time calls would be a welcome change, and would allow originators to include time calls where appropriate without jeopardising the significant risk transfer or capital treatment of the transaction.

3. **Regulatory calls** – While regulatory calls are common and generally uncontested in the synthetic securitisation market, the EBA Report somewhat expanded the scope by including reference to "relevant taxation and accounting provisions". Accounting provisions in particular are typically not included in the regulatory call (whereas tax tends to be covered in a separate termination event), and it will be interesting to see if this is something that becomes more common going forward.

The EBA Report also contains a review of the mechanistic tests and the commensurate risk transfer test. In relation to the mechanistic tests, the EBA noted that, in contrast to the mezzanine test, where the amount of risk required to be transferred is objectively defined as 50% of the risk-weighted amounts of all mezzanine tranches in the securitisation, the first loss test merely refers to the thickness of the first loss tranche exceeding the expected loss on the portfolio, the EBA recommended that the first loss tranche should have a minimum thickness which is sufficient to absorb the lifetime expected losses (EL) and two-thirds of the unexpected losses (UL) on the underlying portfolio (after taking into account the portion of EL and UL which is expected to be covered by synthetic excess spread, where relevant).

More complex were the recommendations on the commensurate risk transfer test. Again, the EBA noted that the CRR itself does not provide any objective rules for how this is to be assessed, which has created a lot of uncertainty in the market. In an attempt to address this, the EBA proposed two objective tests, the "principles based approach test" (or PBA test) and the "CRT test". The PBA test looks at the percentage of the regulatory UL transferred to investors to the regulatory UL on the underlying portfolio, and requires that to be at least equal to 50%. In contrast, the CRT test requires that the percentage of the capital saved by the originator is less than or equal to the percentage of the lifetime EL and UL transferred to investors. Again, in calculating both these tests, the originator should adjust the amount of risk transferred after taking into account any losses expected to be absorbed by synthetic excess spread.

It is interesting that the EBA has sought to provide greater certainty on the application of the commensurate risk transfer test by turning it from a more subjective test into a more objective one. One risk of this is that it will create inconsistent outcomes is some cases, where inherently riskier transactions might pass the test while more conservative transactions could fail. The EBA recognised this risk, but nevertheless has clearly determined that the benefits of certainty for the majority of transactions is to be preferred for the market as a whole.

For the time being these tests remain just recommendations, and while banks are certainly having regard to them in structuring transactions, they do not currently have force of law. Nevertheless, it will be interesting to see what impact these proposals will have on the market in the coming months.

In addition to the specific criteria for significant risk transfer, the EBA Report also addresses the notification process itself, which has been criticised for being opaque and lacking uniformity between the different regulators. The notification procedures vary significantly between different regulators, ranging from a pre-notification and formal notification combination, with the approval being provided pre-closing, to a no-objection letter post-closing, or indeed, no feedback at all. This is further muddled by the fact that the information required for the approval process often differs, with a basic term sheet at one end of the scale to near final documentation with detailed modelling at the other.

The EBA Report seeks to remedy some of these points by recommending that (i) a formal notification framework be established requiring ex ante notification by the originator of the significant risk transfer transaction at the latest 1 month prior to the expected issuance, with pre-defined information/documentation forming part of the submission and (ii) the competent authority should provide explicit point-in-time feedback to the originator on whether significant risk transfer has been achieved, including, as applicable, by way of a statement of no-objection or objection by a pre-set deadline.

Increased visibility on the timing, scope and requirements for the notification and ongoing approval process would greatly assist originators in managing both internal processes and the transaction timeline generally, and would provide more clarity and certainty for all parties involved.

Next steps

The EBA Report was prepared in accordance with the mandate laid down in Articles 244(6) and 245(6) of the CRR, which also gives the Commission the power to adopt a delegated act in accordance with Article 462 to supplement the CRR, taking into account the recommendations laid down by the EBA in the EBA Report. While it is expected that the Commission will ultimately adopt a number of the recommendations laid down in the EBA Report, it is not clear at this time whether this will indeed be by way of a delegated act, or whether the Commission will choose to roll these reforms into the broader review of the Securitisation Regulation and Securitisation Framework in the CRR which is currently underway.

The EBA Report also includes some recommendations that the EBA views as being more appropriately laid out in another legal instrument such as a Guideline, as well as recommendations that would require further amendments to the CRR itself, and that are therefore outside the scope of a delegated act under Articles 244(6) and 245(6). One of these proposals, to require originators to hold capital against synthetic excess spread, has actually already been implemented as part of the Capital Market Recovery Package which entered into force in April 2021 (although the requirement to hold capital against synthetic excess spread will itself not take effect until April 2022, and the precise requirements are yet to be clarified in regulatory technical standards). Again, some of the other recommendations may be adopted as part of the current review of the Securitisation Framework.

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