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Capital Relief Trades: Structuring considerations for synthetic securitizations (a three-part series providing a US and UK perspective)

Part three: Navigating the European rules and regulations

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Introduction and Overview

Synthetic securitization has had a rocky ride in Europe. 2004-2005 was the high watermark, when issuance exceeded EUR 180 billion, the majority of which were arbitrage synthetic securitizations. The financial crisis almost killed off the market, before a gradual recovery began. In 2018, there were 49 European synthetic securitization deals, reaching a post-crisis record of EUR 105 billion. Although arbitrage synthetic securitization has not risen from the flames, there were 244 balance sheet synthetic securitizations between 2008 and the end of 2018.[1] Issuance levels are likely to rise further.

On September 24, 2019, the European Banking Authority published its draft report on an STS Framework for synthetic securitization under Article 45 of the Securitization Regulation (the "EBA Discussion Paper"). The EBA Discussion Paper is driven by the EBA's mandate under the Securitization Regulation[2] to develop a report on the feasibility of a framework for "*simple, transparent and standardized*" (STS) synthetic securitization, limited to balance sheet securitization.

Most of the EU banks that have originated balance sheet synthetic securitizations are domiciled in the United Kingdom, France, Germany, Italy and Spain. There has also been some healthy issuance levels in other EU jurisdictions. Although there is no official data, anecdotally it is clear that the European market for synthetic securitizations is for the most part documented under English law. This means that European synthetic securitization transactions have to navigate capital relief and legal issues arising from a mixture of English law and EU regulation.

This, the third and final part of our series, looks at:

- the criteria for effective credit risk mitigation and the operational requirements for synthetic securitizations under the EU bank capital rules and the Capital Requirements Regulation (the "CRR")[3];
- the insurance regulatory and guarantee issues under English law;
- the potential impact of EU regulation of derivatives contracts under the European Market Infrastructure Regulation (EMIR)[4]; and
- (a) the proposed criteria for a "*simple, transparent and standardized*" (STS) framework for synthetic securitization published by the European Banking Authority (EBA); and (b) the EBA Report on the Credit Risk Mitigation (CRM) Framework dated March 19, 2018 (the "EBA CRM Report").

What Is the Definition of "*synthetic securitization*" in the European Union?

The definition of "*synthetic securitization*" in the European Union is set out in the CRR, as amended in 2017 by Regulation 2017/2401,[5] (the "2017 Amending Regulation") via the EU Securitization Regulation.

The CRR (as amended by the 2017 Amending Regulation) defines "*securitization*" at Article 4(61), by cross-reference to Article 2(19) of the Securitization Regulation, as:

"*a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having all of the following characteristics:*

a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures;

b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme …"

The 2017 Amending Regulation then creates a definition of "*synthetic securitization*" by cross-referring to the corresponding Securitization Regulation definition. This defines a "*synthetic securitization*" as a "*securitization where the transfer of risk is achieved by the use of credit derivatives or guarantees, and the exposures being securitized remain exposures of the originator.*"

Operational Requirements under EU Rules

(I) THE CRR

In Part One of the Series, we discussed how the US Capital Rules are housed in the Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks (Regulation Q). In the European Union, credit institutions and investment firms subject to the CRR may reduce their credit risk capital requirements in respect of loan portfolios and other exposures by obtaining credit protection in transactions that comply with the rules for credit risk mitigation set out in the CRR.

(II) BANK CAPITAL RULES: FOUR POTENTIAL FRAMEWORKS

The EU bank capital rules on capital requirements for credit risk are set out in Part Three, Title II of the CRR. At least four different parts of this credit risk capital framework are potentially relevant for synthetic securitization transactions:

- **Standardized Approach**: This approach requires banks to assign risk weights to assets and off-balance sheet exposures using, among other things, rating agency ratings, and to calculate capital requirements based on the risk weighted exposure amounts.

  Under the "*Standardized Approach*" an affected financial institution must hold qualifying capital equal to at least 8 percent. (before buffers) of risk weighted exposure amounts ("RWEA") with respect to assets and off-balance sheet items.

  Although the Standardized Approach is simpler to apply than the "*Internal Rating Based Approach*" ("IRB") described below. the gap may soon reduce. Under CRR II, once the proposed package of reforms to complete the implementation of Basel III in the European Union comes into force in 2020, the determination of risk weight exposure amounts will become more complex.

- **Internal Ratings-Based Approach:** This is more complex than the Standardized Approach. It is used by the largest and most sophisticated banks which apply regulator-approved risk models to calculate their capital requirements.

  The Internal Ratings-Based Approach has two principal variations. The first, the "*foundation*" approach, known as "F-IRB," takes the permitted operating standards, credit risk mitigation and recognition techniques of the

Standardized Approach and adapts these in the foundation IRB approach, by modifying the risk weight calculations.

Instead of amending the risk weight of an exposure, as is done under the Standardized Approach, F-IRB permits a greater risk sensitivity by taking into account the effects of this mitigation on the different risk components and granting more beneficial capital relief than under the Standardized Approach.

The second variation is the "*advanced*" approach, known as "A-IRB." A-IRB allows banks to include their own estimates of probability of default (PD) and loss given default (LGD) in its calculations of how much qualifying capital it must hold.

An advanced financial institution's decision to adopt the Internal Ratings-Based Approach under either F-IRB or A-IRB, will affect which CRM rules it must apply.

- **Securitization:** The Securitization Framework is not an alternative to the Standardized Approach and Internal Ratings-Based Approach, but instead, interacts with these two approaches.

  Risk weights for securitization positions under these approaches, are determined using the "*Securitization Internal Ratings-Based Approach*" (SEC-IRBA). This approach takes into account the Internal Ratings-Based Approach or the "*Securitization Standardized Approach*" (SEC-SA) based on the Internal Ratings-Based Approach or the Standardized Approach capital requirement for the relevant underlying asset (for example an SME loan).

- **Credit Risk Mitigation (CRM):** As further described above, for a pool of underlying assets, an affected financial institution would apply either the Standardized Approach or the Internal Ratings-Based Approach, with the latter approach being reserved for those financial institutions with the most complex risk management systems, and accompanying regulatory approval.

  The CRM framework sets out CRM rules for banks applying F-IRB and A-IRB frameworks. The A-IRB framework has its own CRM rules (which also refer to parts of the main CRM rules). If the referenced exposures are securitization exposures or the CRM creates securitization exposures, then the Securitization Framework will apply.

(III) CREDIT RISK MITIGATION/CRM AND SYNTHETIC SECURITIZATION

Synthetic Securitization is part of the Securitization Framework. It applies, as per the definitions we discussed above, when a bank transfers a tranche or tranches of credit risk of an exposure or pool of exposures to another party by means of a guarantee or credit derivatives – i.e., unfunded credit risk mitigation techniques. In essence it is a technique to reduce the credit risk associated with an exposure an institution holds, which is true of all CRM but only when the CRM creates credit risk tranching does it constitute synthetic securitization.

The CRR provides that CRM reduces RWEA by reducing the risk weight applied to covered exposures or by reducing other measures of credit risk based on probability of default (PD) or loss given default (LGD) used to calculate RWEA.

(IV) FUNDED OR UNFUNDED CRM

CRM can be either funded or unfunded. Unfunded credit protection takes the form of a guarantee or a credit derivative. The reduction of an institution's credit risk on its exposure derives from the obligation of a third party to pay a credit protection amount on a counterparty or borrower event default or credit event.

Funded credit protection, is where a financial institution seeking credit risk mitigation holds collateral, either directly or indirectly, against the third party's obligation to pay the credit protection amount.

Essentially, it is a credit risk mitigation technique where the reduction of the credit risk on the exposure derives from the institution's right on a counterparty event of default or credit event: (a) to liquidate, obtain transfer, appropriate, or retain assets or amounts; or (b) reduce exposure to, or to replace it with, the amount of the difference between the amount of the exposure and the amount of a claim on the institution.

Funded credit protection can involve a credit derivative or guarantee, being supported by an SPV note structure, with credit protection payments supported by the liquidation of collateral.

(V) EFFECTIVE CRM REQUIREMENTS

CRM may only reduce bank capital requirements if specified conditions are met. These requirements include that the CRM arrangement is effective and enforceable in all relevant jurisdictions, and that the protection buyer has received a legal opinion to confirm the enforceability requirement under the CRR.

For unfunded CRM the credit protection provider must be an eligible provider, and the credit protection contract must be an eligible contract. Eligible providers include various types of public and private sector entities, such as corporate entities that have a qualified rating agency rating or, for a bank using the IRB approach, an internal rating by that bank.

For guarantees of securitization exposures, and some other purposes, although there is no minimum rating requirement for the protection provider, the protection provider must have a qualifying rating of A- or higher at the start of the transaction and investment grade ongoing from an external credit assessment institution ("ECAI") or, if the protection buyer is a bank using the IRB approach (and whether or not it has a rating from an ECAI), the protection provider needs to have an internal rating from the protected bank. SPEs may not be protection providers unless they fully cash collateralize their obligations.

The CRR, following the Basel framework, gives the types of eligible contracts for unfunded CRM as guarantees and credit derivatives.

It does not refer to insurance policies as such as eligible CRM. However, banking regulators have accepted credit insurance policies as CRM, provided the policies meet the other requirements that apply to guarantees used as CRM.[6]

The requirements that apply to guarantees and credit derivatives mainly relate to the certainty of the bank receiving payment from the credit protection provider if the primary obligor defaults.

First, the contract must provide a direct payment obligation from the protection provider to the bank.

The extent of protection, or scope of coverage, must be "*incontrovertible*" – clear and indisputable.

Any conditions on the obligation to pay, and any rights for the protection provider to cancel or terminate the protection, must be limited to events within the control of the protected bank.

The contract may not provide for increased cost of the protection based on deterioration of the covered credit. For a guarantee to be used as CRM, in addition, it needs to give the protected bank the right to pursue the guarantor for payment when the primary obligor fails to pay or another specified default event occurs. This is called "*pay now claim later*," and is a level which few credit insurance policies include.

The bank must be able to exercise this right "*in a timely manner*," which does not have to be the following day but may be up to 24 months. The UK PRA consulted on a fairly strict interpretation of this requirement, but did not include that in its final policy statement.

The guarantee must be a written obligation of the guarantor, and it must either cover all payments to which the financial institution is entitled, or, if it covers less than all payments, the capital benefit must be adjusted to reflect that.

For example, a guarantee might cover a pro rata share of a loan and the capital benefit would be applied to that pro rata share.

(VI) INTERSECTION OF CRM AND SECURITIZATION CAPITAL FRAMEWORK

The effect of CRM will be similar to that for other types of exposures, in that the risk weight or other credit risk measure of the protection provider will be substituted for that which would otherwise apply to the covered exposure or covered portion, and there will be an adjustment for any differences in maturity if the term of the protection is shorter than that of the exposure.

Securitizations can be "*traditional*," where the underlying assets are sold to an SPE or to investors, or "*synthetic*," where credit risk is transferred by means of a guarantee or credit derivative. So, where CRM covers a segment of credit risk of a pool of exposures, such as the mezzanine or second-loss piece of a pool of loans, very often that creates a synthetic securitization.

For the securitization to be effective for purposes of bank capital requirements under the Securitization Framework, a number of conditions must be met. The most important of these is a transfer of significant credit risk from the bank to third parties.

While this is a general requirement under the Basel framework, in the European Union, CRR (Article 245) provides a formula to give guidance on significant risk transfer.

Generally the bank must retain not more than half of the mezzanine tranche (by RWEA). However, if there is no mezzanine tranche, and the originator can demonstrate 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, the originator is permitted to retain not more than 20 percent of exposure value of the first loss tranche.

Amendments implemented through the 2017 Amending Regulation made some changes to these rules. The "*mezzanine*" definition no longer refers to credit ratings, and the first loss option no longer refers to 1250 percent risk weighting.[7]

However, regulators can override this formula if they find the transfer of risk is not commensurate with the amount of capital relief claimed. This means that regulators have more discretion in deciding when capital reduction is appropriate, and so banks generally want to discuss transactions with regulators before they complete them.

Other operating conditions for synthetic securitization overlap somewhat with those for effective CRM: in addition to the general CRM requirements, there must be no terms such as price increases on deterioration in credit quality that effectively transfer the risk back onto the bank.

Early termination by the bank is generally allowed only in limited circumstances. Early termination in the case of a 10 percent clean-up call is allowed. Time calls, where at a point in time, the time period running from the transaction issue date is equal to or above the weighted average life of the initial reference portfolio at the issue date, are also permissible in restricted circumstances. However, the only other permitted circumstance is following a narrow range of regulatory events. Other repurchases or early termination must be on arms-length terms.

Insurance Regulatory Issues under English law

As in the United States, for transactions governed by English law (as most deals are in the European Union), when structuring a synthetic securitization, which is documented using a guarantee or credit derivative, avoiding insurance regulation is a significant issue.

This is because, under English law, there is no definitive definition of "*insurance*" or "*contract of insurance*." The leading case on the meaning of the term "*contract of insurance*" is *Prudential Insurance Company v Commissioners of Inland Revenue* [1904] 2KBD 658, which is well over 100 years old and generations before credit derivatives and synthetic securitization were ever dreamt of.

In that case, the judge, Channel J, set out three requirements for a contract of insurance:

i. "*it must be a contract whereby for some consideration, usually but not necessarily for periodical payments called premiums, you secure to yourself some benefit, usually but not necessarily the payment of a sum of money, upon the happening of some event*": a "***consideration to secure a benefit***" requirement;

ii. "*the event must be one which involves some amount of uncertainty*": an "***uncertainty requirement***"; and

iii. "*the insurance must be against something – that is to say, the uncertain event … must be an event which is prima facie adverse to the interest of the assured*": an "***insurable interest***" requirement.

While the definition does not have the force of statute, it has been cited with approval in other cases. Indeed, the FCA's "Perimeter Guidance Manual," in setting out its approach to this area of regulation, refers specifically to the *Prudential* case and the three requirements set out in it. The three *Prudential* requirements therefore carry some weight in deciding how to interpret the expression "*contract of insurance*" in the UK Regulated Activities Order.[8]

The potential characterization of derivatives arrangements as insurance has been most thoroughly considered in relation to credit derivatives.

In this area, and on the basis of market uncertainty, the trade body ISDA commissioned an opinion by Robin Potts QC dated June 24, 1997 (the "ISDA Opinion") on whether or not credit default options/swaps are contracts of insurance under the Insurance Companies Act 1982 and/or at common law.

Under a credit derivative transaction or guarantee in a synthetic securitization, the credit protection payer receives a premium from a credit protection buyer in return for assuming the risk that a credit event (i.e., a bankruptcy, failure to pay or a restructuring) may impact on a reference entity. If this occurs, the credit protection payer will, broadly speaking, pay the difference between the pre-default and post-default value of a reference asset.

In the ISDA Opinion, Potts opined, in summary, that:

i. a contract of insurance is a contract against the risk of loss of a potential payee; and that the requirement for "*insurable interest*" is simply another way of expressing the requirement that an insurance contract must be a contract against the risk of loss;

ii. in the case of a credit event under a credit derivative, a payment must be made to the payee irrespective of whether or not that payee has suffered loss or been exposed to the actual risk of loss;

iii. while the economic effect of certain credit derivatives transactions may be similar to the economic effect of a contract of insurance, the relevant authorities emphasise that economic effect is not the test to be applied to the characterisation of a transaction; and that the rights and obligations specified in the relevant contract must instead be addressed. Further the contract ought to be construed at the time it was entered into and

not subsequently, so that, if a party subsequently receives payment that offsets a loss it has suffered it will not affect the characterisation of the transaction; and

iv. credit derivatives are not contracts of insurance because:

A. the payment obligation is not conditional on the payee's sustaining a loss or having a risk of loss; and

B. the contract is thus not one which seeks to protect an insurable interest on the part of the payee.

Credit derivatives and guarantees in synthetic securitization transactions are therefore structured so that the *Prudential Requirements,* on the basis analyzed by the ISDA Opinion, are not met. This is done through not requiring the entity holding the underlying reference assets to continue to hold them and deeming a credit protection payment to be payable whether or not the credit protection receiver, or beneficiary under the guarantee, has directly suffered a loss. This is intended to create no "*insurable interest*."

The conclusions made in the ISDA Opinion have not been tested before the English courts. However, there is market reliance on the Potts' opinion and an absence of other relevant judicial authority, support for the view that if an English court reached the same conclusions as the Potts' opinion, it would also determine that if a synthetic securitization does not have an "*insurable interest*" and has not otherwise met the tests of being characterised as a contract of insurance within the meaning of that term as used in the Regulated Activities Order, then it will not be a contract of insurance.

Swap Regulatory Issues

The issues relating to derivatives regulation for synthetic securitizations are not as challenging under EU rules as they are under the US rules.

EMIR imposes legislative challenges for synthetic securitizations.

Where the relevant credit risk mitigation instrument is a credit derivative, then the key issues the parties to a transaction must analyze is whether (a) the transaction must be reported to a trade repository; and (b) whether any margining requirements apply.

The answer will depend on the jurisdiction and legal status of the parties, and there are many nuances. Where one of the parties is based in the European Union, then trade reporting requirements are likely to apply. Where one of the parties is not based in the European Union, but the other is, there may be additional reporting requirements in the jurisdiction of the Non-EU party.

EMIR also imposes obligations relating the exchange of margin. Variation margin must be exchanged against derivatives exposures between financial institutions and the largest non-financial institution derivatives market participants. So this captures banks, insurance companies, pension funds, asset managers and hedge funds: the core participant group in synthetic securitizations.

The largest market participants also need to exchange initial margin: a buffer amount of margin. Absent an avoidance motive SPVs do not need to exchange margin under EMIR with their derivatives counterparties.

Margin requirements can affect the economic attractiveness of a synthetic securitization, and institutions engaging in synthetic securitization must weigh up these costs.

Guarantees do not on a prima facie basis fall under EMIR. However, an institution using a guarantee for CRM purposes must consider whether the guarantee is a derivative in substance, if not form, and consider whether the provisions of EMIR discussed above, should be deemed to apply.

EBA Discussion Paper: Draft Report on STS Framework for Synthetic Securitization

The Securitization Regulation allows traditional securitizations to benefit from preferential regulatory capital treatment if they meet the applicable STS criteria together with some additional requirements under the CRR (pursuant to the 2017 Amending Regulation). However, it was decided not to include synthetic securitizations in the initial STS framework due to concerns about additional counterparty credit risk and complexity, and, instead, the question of STS for synthetic securitizations was postponed for future consideration. It was recognized in the Securitization Regulation that the EBA had already established a possible set of STS criteria for synthetic securitization in its Report on Synthetic Securitization published in 2015. Article 270 of the CRR, as amended by the 2017 Amending Regulation, already allows for preferential regulatory treatment of synthetic securitizations on a limited basis with respect to senior tranches of SME portfolios retained by originator credit institutions which meet certain requirements.

Article 45 of the Securitization Regulation required the EBA to publish a report on the feasibility of a specific framework for STS synthetic securitization by July 2, 2019, following which the European Commission (the "Commission") is required to submit a report and, if appropriate, a legislative proposal, to the Parliament and the Council by January 2, 2020. Given the delay in publishing the EBA Discussion Paper, the Commission report and legislative proposal is likely to be delayed as well. The creation of such STS framework is limited to balance sheet synthetic securitization and arbitrage securitizations will not be within its scope.

The EBA Discussion Paper sets out a set of proposed STS criteria for synthetic securitizations. These criteria broadly follow the existing STS criteria for non-ABCP securitizations in the Securitization Regulation, with some amendments and with some additional criteria covering matters which are specific to synthetic transactions. These additional criteria include certain credit events to be included in the credit protection agreement, provisions in relation to the calculation and timing of credit protection payments and requirements for eligible credit protection arrangements.

The EBA Discussion Paper identifies some points in favor of developing an STS framework for synthetic securitization which include increased transparency, further standardization and the potential positive impact on the financial and capital markets and the real economy. However, it also notes some points against creating such a framework, including the fact that there is no equivalent framework for synthetic securitization under the revised Basel securitization framework, where traditional securitizations that meet the criteria for "*simple, comparable and standardized*" securitizations can benefit from alternative capital treatment. The EBA concludes that an STS framework should be established for balance sheet synthetic securitizations, based on the proposed STS criteria.

The EBA Discussion Paper also separately considers the question of whether synthetic securitizations which meet the STS criteria should be able to benefit from preferential regulatory capital treatment. While it notes that this would have certain benefits, such as increased risk sensitivity, ensuring a level playing field with traditional securitization and the positive impact on the markets, and despite recognizing that synthetic securitizations perform as well as traditional securitizations, the EBA refrains from providing a recommendation as regards differentiated capital treatment for STS synthetic transactions.

The prospect of obtaining preferential regulatory capital treatment for STS synthetic securitizations is a very important issue for many market participants, and they will be hoping that this will be considered further and that this can be achieved.

The deadline for comments on the EBA Discussion Paper is November 25, 2019.

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Endnotes

1 The EBA Draft Report on Synthetic Securitization, EBA/Op/2015/26

2 Regulation (EU) 2017/2402 of the European Parliament and of the Council of December 12, 2017 laying down a general framework for securitization and creating a specific framework for simple, transparent and standardized securitization, and amending Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No 1060/2009 and (EU) No 648/2012

3 Regulation (EU) (575/2013) of the European Parliament and of the Council of June 26, 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012

4 Regulation (EU) No 648/2012 of the European Parliament and of the Council of July 4, 2012 on OTC derivatives, central counterparties and trade repositories, as amended, and its related regulatory technical standards

5 Regulation (EU) 2017/2401 of the European Parliament and of the Council of December 12, 2017 amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms

6 Question ID 2014_768 of EBA Single Rulebook Q&A; EBA Report on CRM Framework, March 19, 2018, paragraph 36.

7 Article 242(17),(18)

8 Assisting in performing or administering a contract of insurance is a regulated activity under article 39A of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) (the "Regulated Activities Order").