Why Are US Banks Interested in Synthetic Securitizations?

A US bank may be interested in a synthetic securitization for a variety of reasons, including risk mitigation through the sharing of credit risk with investors or financing assets that cannot easily be sold or transferred in a traditional securitization. However, the primary reason for engaging in a synthetic securitization is typically the release of capital.

Under the US capital rules, banks are able to reduce risk-based regulatory capital required for residential mortgage and other loan portfolios by converting exposures from wholesale or retail exposures to securitization exposures. This is due to the fact that the risk-weight under the US capital rules for typical senior securitization exposures is 20 percent, while the risk-weight for most other exposures is 100 percent for banks using the standardized approach. That means a senior securitization exposure can have required capital of 1/5 the amount required for holding a position in the unsecuritized loans. This result makes sense given that credit risk has actually been transferred in typical securitization transactions. However, in this regard, not all securitizations are treated equally, at least not under the US capital rules.

Operational Requirements under US Capital Rules

The operational criteria for traditional securitizations under US capital rules differ from those under the Basel framework in a way that can create a significant relative disadvantage to US banks. The operational
criteria for traditional securitizations under the US capital rules require that the underlying exposures not be on the transferring bank’s consolidated balance sheet under GAAP. In contrast, the Basel framework requires, among other requirements, that a traditional securitization include a transfer to third parties of a “significant credit risk associated with the underlying exposures,” but does not require that the underlying exposures be removed from the transferring bank’s balance sheet.

Unlike the operational criteria for traditional securitizations under US capital rules, the operational criteria for synthetic securitizations under the US capital rules do not require off-balance sheet treatment (but do require some transfer of credit risk in the underlying exposures). As a result, engaging in a synthetic securitization and recognizing the use of a credit risk mitigant to hedge underlying exposures provides a potential means of capital relief.

Because a synthetic securitization does not remove the underlying assets from the balance sheet of the transferring bank, the bank will look to the rules regarding credit risk mitigation to determine the resulting capital treatment of the exposure it holds in relation to the transferred tranche of credit risk. This normally will be a zero risk-weight if the exposure is secured by financial collateral (i.e., cash on deposit including cash held by a third-party custodian or trustee) or it will be a risk-weight corresponding to the risk weight for the counterparty providing the guarantee or credit derivative, if that counterparty is an “eligible guarantor” under the US capital rules.

As an initial matter, in order to constitute a “synthetic securitization,” as defined in the US capital rules, a transaction must meet the following requirements:

1. All or a portion of the credit risk of one or more underlying exposures is transferred to one or more third parties through the use of one or more credit derivatives or guarantees;
2. The credit risk associated with the underlying exposures has been separated into at least two tranches that reflect different levels of seniority;
3. Performance of the securitization exposures depends upon the performance of the underlying exposures; and
4. All or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities).

In addition, the bank must also satisfy the operational requirements for synthetic securitizations, including that the credit risk mitigant is one of the following three options: (1) financial collateral, (2) a guarantee that meets all criteria as set forth in the definition of “eligible guarantee” (except for the criteria in paragraph (3) of the definition) or (3) a credit derivative that meets all of the criteria as set forth in the definition of “eligible credit derivative” (except for the criteria in paragraph (3) of the definition of “eligible guarantee.”

Because the operational criteria for synthetic securitizations recognize guarantees and
credit derivatives as permissible forms of credit risk mitigants, those structuring a US capital relief trade (CRT)® structured as a synthetic securitization typically will find themselves debating between a guarantee or a credit derivative, and this decision will involve a number of regulatory considerations, including compliance with insurance regulations, swap regulations, the US risk retention rules and the Volcker Rule. Below, we discuss a number of the legal structuring considerations relevant to a typical CRT structured as a synthetic securitization. The discussion is intended to highlight the primary legal structuring considerations that may be encountered in doing a CRT in the United States, but such considerations may not apply to all structures, and a CRT may give rise to additional legal, regulatory and accounting considerations not discussed in this article.

**Insurance Regulatory Issues**

One of the more challenging issues in structuring a CRT is navigating between avoiding insurance regulation on the one hand, and swap regulation on the other. In the case of insurance regulation, the analysis is complicated by the fact that in the United States the business of insurance is primarily regulated at the state level, so whether a guarantee is an “insurance contract” subject to state insurance regulation will be a question of the applicable state’s law—and how that law is interpreted by the state’s insurance regulatory authorities. A further complication is determining which states’ laws may apply to a transaction. Generally, insurance regulatory jurisdiction in the United States is based upon where the insurance contract (or putative insurance contract) is solicited, negotiated, issued and/or delivered.

Taking New York state as a representative example, an “insurance contract” is defined in N.Y. Ins. Law § 1101(a)(1) as any agreement or other transaction whereby one party, the “insurer,” is obligated to confer a benefit of pecuniary value upon another party, the “insured” or “beneficiary,” dependent upon the happening of a fortuitous event in which the insured or beneficiary has, or is expected to have at the time of such happening, a material interest which will be adversely affected by the happening of such event. Under N.Y. Ins. Law §1101(a)(3), a CRT structured as a guarantee will face potential regulation as an insurance contract if made by a warrantor, guarantor or surety who is engaged in an “insurance business,” which, as discussed below, is further defined in the New York insurance.
monetary obligation to pay principal or interest due or payable with respect to such instrument or obligation, when such failure is the result of a financial default or insolvency.

Under N.Y. Ins. Law § 1101(b)(1)(B), whether a guarantor is engaged in an insurance business depends on whether it is “making, or proposing to make, as warrantor, guarantor or surety, any contract of warranty, guaranty or suretyship as a vocation and not as merely incidental to any other legitimate business or activity of the warrantor, guarantor or surety ....” The most recent interpretive authority for when a guaranty is not conducted “as a vocation” but is “merely incidental” is a 2003 opinion issued by the Office of General Counsel of the New York State Insurance Department.11

Under the reasoning articulated in that opinion, an “incidental” guaranty includes a guaranty by a parent company of a subsidiary’s obligations, a personal guaranty by a shareholder of a closely-held corporation’s obligations and a loan guaranty offered by a cooperative corporation to its owner-members for a nominal fee. By contrast, where a guaranty is provided to unrelated third parties, covers obligations of unrelated parties and is provided for a risk-based fee, that seems more like a “vocation”—and if a special purpose entity (SPE) provides the guaranty as its sole function, that would seem even more like a “vocation.”

The consequence of a contract falling within the above definitions of “insurance” or “financial guaranty insurance,” or of being a guaranty that is conducted as a vocation and not merely incidental to any other legitimate business or activity of the guarantor, is that the guarantor could be deemed to be engaged in an unauthorized insurance business and therefore subject to civil, and theoretically even criminal, penalties.

Notwithstanding the above, arguments could be made as to why a guaranty may not be insurance under applicable state law. For example, if a CRT does not require the beneficiary or protection buyer, as applicable, to own the underlying exposures, the instrument would generally not meet one of the defining characteristics of insurance, which is that the beneficiary have an insurable interest in the underlying exposures.12

In addition, in cash collateralized CRTs, the guarantor arguably does not have any future obligation to confer a benefit of pecuniary value, because it has satisfied all of its obligations upon the furnishing of cash collateral and has no future payment obligations. It should be noted, we are not aware of any insurance department having approved of such interpretation, and those structuring CRTs will need to consult with insurance counsel in applicable jurisdictions.

**Swap Regulatory Issues**

**DODD FRANK AND COMMODITY POOL REGULATION**

A CRT transaction documented as a swap will need to navigate potential regulation as a swap.13 Moreover, the form in which the risk transfer instrument is documented is not dispositive. Therefore, even if a CRT transaction is documented as a financial
guaranty rather than a credit default swap or other derivative, those structuring the transaction should still evaluate the possibility of swap characterization and whether compliance with the CEA is advisable. One also should consult the applicable rules promulgated thereunder by the Commodity Futures Trading Commission (CFTC).

If the CRT transaction is documented as a swap, a host of regulatory implications follow. For example, the parties will need to consider potential registration (or a potential exclusion or exemption therefrom) as a swap dealer, introducing broker, a commodity pool operator (CPO) or, for managed transactions, a commodity trading advisor (CTA). In addition, the parties will need to address the uncleared margin, trade reporting, and recordkeeping obligations under the Commodity Exchange Act, among other things.

In the context of securitizations, the most common registration trigger is that of a CPO, which functions as a sponsor or operator of a commodity pool (e.g., an SPE that enters into swaps). The CPO either itself makes trading decisions for the commodity pool or engages a CTA to do so.

Generally, a commodity pool is an enterprise in which funds contributed by a number of persons are combined, or pooled, for the purpose of trading commodity interests—which are defined to include swaps, OTC options, futures contracts, options on futures contracts, retail off-exchange forex transactions, and retail commodity transactions—or investments in another commodity pool. In many CRTs, the provider under the swap, guarantee or other loss sharing arrangement will be an SPE. Because the SPE will have received funds for the purpose of engaging in a swap transaction or a transaction potentially characterized as a swap transaction, the SPE may be characterized as a commodity pool. The CFTC has issued a number of no-action letters relating to securitization structures that use swaps. In particular, in CFTC No-Action Letter 14-111, CFTC staff found that an SPE that holds an interest in a swap creating synthetic exposure to the risk of mortgage loans held or securitized by Fannie Mae and Freddie Mac would be considered a commodity pool. CFTC staff stated that, absent relief, the GSEs operating the SPEs would be required to register with the CFTC as CPOs. The GSEs were seeking to avail themselves of the exemption under CFTC Rule 4.13(a)(3), but the transactions presented a significant question under the “marketing” prong of the exemption because the principal return-generating assets of the SPEs would be swaps. In the no-action letter, which is discussed further below, staff granted no-action relief from CPO registration provided that the GSEs and their SPEs complied with the requirements set forth in Rule 4.13(a)(3), as construed in the letter, and numerous other conditions discussed in the letter (not all of which are discussed in this article). In a subsequent letter, CFTC No-Action Letter 14-152, CFTC staff provided similar relief to operators of insurance-linked securities issuers.
Under Rule 4.13(a)(3), an operator can claim exemptive relief from the CPO registration requirements if a pool meets certain conditions relating to marketing, commodity interest exposure and investor qualification. More specifically, the following conditions must be satisfied on a pool-by-pool basis for those pools for which the operator claims the Rule 4.13(a)(3) exemption:

i. **Not marketed to the public** – interests in the pool must be exempt from registration under the Securities Act of 1933 and must be offered and sold without marketing to the public in the United States;¹⁷

ii. **Commodity interest exposure** – the pool must engage in a sufficiently limited amount of commodity interest trading (i.e., satisfy a de minimis test discussed below);

iii. **Sophisticated investors** – the pool operator must reasonably believe at the time of investment that each investor in the pool meets certain sophistication criteria; and

iv. **Marketing of the pool** – investments in the pool must not be marketed as a vehicle for trading in a commodity interest exposure.

In addition, certain requirements apply with regard to investor disclosure, notice filing with the National Futures Association (and updating and renewal of the notice), books and records, and submission to special calls from the CFTC to demonstrate eligibility and compliance with the exemption criteria.

As noted above, a condition for the exemptive relief from CPO registration under Rule 4.13(a)(3) is that the pool must engage in a sufficiently limited amount of commodity interest trading. For this purpose, a pool is considered to have a sufficiently limited commodity interest exposure if, at the relevant times, it meets one of the following de minimis tests: (a) the aggregate premiums are less than or equal to 5 percent of the liquidation value of the pool’s portfolio; or (b) the aggregate net notional value of the pool’s commodity interest positions is less than or equal to 100 percent of the liquidation value of the pool’s portfolio (Notional Value Test). Here, liquidation value is to be determined after taking into account any unrealized profits and losses on commodity interest positions that the pool has entered into.¹⁸ The notional value of an uncleared swap is the amount reported by the reporting counterparty as the notional amount of the swap under Part 45 of the CFTC’s regulations.¹⁹

In No-Action Letter 14-111, CFTC staff addressed the application of the Notional Value Test to a credit default swap between a GSE and an SPE. Under the facts considered in the letter, note proceeds were used to collateralize the SPE’s obligations to make payments of principal to noteholders and payments in respect of credit events to the GSE. In that letter, staff found that the Notional Value Test was satisfied because:

i. the GSEs (as operators of the SPEs) had represented that the notional amount²⁰ of the swap between the SPE and
the GSE (as counterparty) would not exceed the amount of collateral raised from the SPE’s sale of notes; 

ii. collateral would be invested in certain short-term, highly liquid assets with limited market risk; and 

iii. the notional value of the swap would be reduced when defaulting mortgages exited the pool and the assets held by the SPE would be liquidated to pay credit coverage to the GSE, thereby reducing the collateral in the same amount as the notional value reduction.

With respect to the marketing prong, CFTC staff noted that a facts and circumstances analysis must be applied and that factors enumerated in the context of revisions to another CPO-related rule were useful in interpreting the marketing prong of Rule 4.13(a)(3). For the GSE’s proposed transactions, CFTC staff found it significant that the swap transaction would “serve as the conduit for exposure to the mortgage credit risk of assets actually held by a counterparty to said swap, and the terms of the swap will not be a source of investment returns or losses beyond those directly correlated to the underlying mortgage loans, as there is no leverage embedded in the terms of the swap.”

In summary, although a no-action letter cannot be relied upon by persons not addressed by the letter, those structuring CRT transactions may consider applying the reasoning articulated in the CFTC’s no-action letters when determining whether the Rule 4.13(a)(3) exemption might be available to a CRT transaction involving swaps. In particular, parties may be able to structure their CRT transaction to comply with the Notional Value Test and, in placing securities to investors, observe the manner of offering and investor qualification conditions of Rule 4.13(a)(3). It should be noted that a more nuanced facts and circumstances analysis will apply to the marketing prong, including rigorous evaluation of the terms of the swap and other features of the CRT transaction that may affect investor returns and losses. But with the interpretive guideposts provided by the no-action letters and other CFTC guidance, counsel may be able to conclude with sufficient comfort that the CRT transaction, if marketed in accordance with the associated offering documentation, complies with the marketing prong of Rule 4.13(a)(3).

CHARACTERIZATION OF CREDIT LINKED NOTES AND SIMILAR CONTRACTS AS “SWAPS” OR OTHER COMMODITY INTERESTS

CRT transactions often use credit-linked notes (CLNs) or similar contracts that provide loss protection similar to credit default swaps and other derivative contracts, but are issued in the form of securities having debt-like characteristics. Such instruments may be able to meet the criteria of the “hybrid instruments” exclusion under the Commodity Exchange Act (CEA) for instruments that are predominantly securities. Under the CEA, a “hybrid instrument” is defined as “a security having one or more payments indexed to the value, level, or rate of, or providing for the delivery of, one or more commodities,” and
Section 2(f) excludes from CFTC jurisdiction “a hybrid instrument that is predominantly a security.” Section 2(f) states that, a hybrid instrument shall be considered to be predominantly a security if the following characteristics are met:

A. “the issuer of the hybrid instrument receives payment in full of the purchase price of the hybrid instrument, substantially contemporaneously with delivery of the hybrid instrument;”

B. “the purchaser or holder of the hybrid instrument is not required to make any payment to the issuer in addition to the purchase price paid on delivery (or option on such a contract) subject to this Act.”

In addition, the credit-linked notes or similar instruments may be able to meet the criteria of an exclusion from the definition of “swap” that is applicable to “any note, bond, or evidence of indebtedness that is a security, as defined in section 2(a)(1) of the Securities Act of 1933.”

Endnotes

1 References to sections of the US capital rules are to Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks (Regulation Q), 12 CFR §217 (2013) [hereinafter “Regulation Q”].

2 As a result of the Collins Amendment under Dodd Frank, the standardized approach will be the binding constraint even for most banks subject to the advanced approaches.

3 §217.41(a)(1) of Regulation Q.

4 See definition of “Eligible guarantor” in §217.2 of Regulation Q.

“Eligible guarantor means:

(1) A sovereign, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, a Federal Home Loan Bank, Federal Agricultural Mortgage Corporation (Farmer Mac), a multilateral development bank (MDB), a depository institution, a bank holding company, a savings and loan holding company, a credit union, a foreign bank, or a qualifying central counterparty; or

(2) An entity (other than a special purpose entity):

(i) That at the time the guarantee is issued or anytime thereafter, has issued and outstanding an unsecured debt security without credit enhancement that is investment grade;

(ii) Whose creditworthiness is not positively correlated with the credit risk of the exposures for which it has provided guarantees; and

(iii) That is not an insurance company engaged predominately in the business of providing credit protection (such as a monoline bond insurer or re-insurer).”

5 See definition of “Synthetic Securitization” in §217.2 of Regulation Q.

6 See §217.41(b) of Regulation Q for a full description of all operational criteria for synthetic securitizations.

7 See definition of “Eligible guarantee” in §217.2 of Regulation Q.

“means a guarantee that:

(1) Is written;

(2) Is either:
(i) Unconditional; or

(ii) A contingent obligation of the US government or its agencies, the enforceability of which is dependent upon some affirmative action on the part of the beneficiary of the guarantee or a third party (for example, meeting servicing requirements);

(3) Covers all or a pro rata portion of all contractual payments of the obligated party on the reference exposure;

(4) Gives the beneficiary a direct claim against the protection provider;

(5) Is not unilaterally cancelable by the protection provider for reasons other than the breach of the contract by the beneficiary;

(6) Except for a guarantee by a sovereign, is legally enforceable against the protection provider in a jurisdiction where the protection provider has sufficient assets against which a judgment may be attached and enforced;

(7) Requires the protection provider to make payment to the beneficiary on the occurrence of a default (as defined in the guarantee) of the obligated party on the reference exposure in a timely manner without the beneficiary first having to take legal actions to pursue the obligor for payment;

(8) Does not increase the beneficiary’s cost of credit protection on the guarantee in response to deterioration in the credit quality of the reference exposure;

(9) Is not provided by an affiliate of the national bank or Federal savings association, unless the affiliate is an insured depository institution, foreign bank, securities broker or dealer, or insurance company that:

(i) Does not control the national bank or Federal savings association; and

(ii) Is subject to consolidated supervision and regulation comparable to that imposed on depository institutions, US securities broker-dealers, or US insurance companies (as the case may be); and

(10) For purposes of §§3.141 through 3.145 and subpart D of this part, is provided by an eligible guarantor.”

See definition of “Eligible credit derivative” in §217.2 of Regulation Q.

“Eligible credit derivative means a credit derivative in the form of a credit default swap, nth-to-default swap, total return swap, or any other form of credit derivative approved by the OCC, provided that:

(1) The contract meets the requirements of an eligible guarantee and has been confirmed by the protection purchaser and the protection provider;

(2) Any assignment of the contract has been confirmed by all relevant parties;

(3) If the credit derivative is a credit default swap or nth-to-default swap, the contract includes the following credit events:

(i) Failure to pay any amount due under the terms of the reference exposure, subject to any applicable minimal payment threshold that is consistent with standard market practice and with a grace period that is closely in line with the grace period of the reference exposure; and

(ii) Receivership, insolvency, liquidation, conservatorship or inability of the reference exposure issuer to pay its debts, or its failure or admission in writing of its inability generally to pay its debts as they become due, and similar events;

(4) The terms and conditions dictating the manner in which the contract is to be settled are incorporated into the contract;

(5) If the contract allows for cash settlement, the contract incorporates a robust valuation process to estimate loss reliably and specifies a reasonable period for obtaining post-credit event valuations of the reference exposure;

(6) If the contract requires the protection purchaser to transfer an exposure to the protection provider at settlement, the terms of at least one of the exposures that is permitted to be transferred under the contract provide that any required consent to transfer may not be unreasonably withheld;

(7) If the credit derivative is a credit default swap or nth-to-default swap, the contract clearly identifies the parties responsible for determining whether a credit event has occurred, specifies that this determination is not the sole responsibility of the protection provider, and gives the protection purchaser the right to notify the protection provider of the occurrence of a credit event; and

(8) If the credit derivative is a total return swap and the national bank or Federal savings association records net payments received on the swap as net income, the national bank or Federal savings association records offsetting deterioration in the value of the hedged exposure (either through reductions in fair value or by an addition to reserves).”
Capital relief trades are sometimes referred to as “capital release transactions” or “credit risk transfer” (also shortened to “CRT”). As noted by Richard Robb in “What’s in a Name?”, the term “CRT” can be particularly confusing for US market participants because such term is also used to refer to credit risk transfer deals involving housing mortgage collateral issued by the United States GSEs. Structured Credit Investor, 2018 Guide to Capital Relief Trades, p. 6.

“Fortuitous event” means any occurrence or failure to occur which is, or is assumed by the parties to be, to a substantial extent beyond the control of either party. N.Y. Ins. Law § 1101(a)(2).


See, for example, the above quoted definition of “financial guaranty insurance” under the N.Y. Insurance Law which requires “proof of occurrence of financial loss, to an insured claimant, obligee or indemnitee” as a result of any of the events enumerated in the statute. In addition, the “insurance safe harbor” regulations issued by the SEC and CFTC under Dodd-Frank, in order to delineate the boundary between insurance contracts and swaps, (i) require the beneficiary of an insurance contract to have an insurable interest and carry the risk of loss with respect to that interest continuously throughout the duration of the contract and (ii) limit the beneficiary’s entitlement to payment to the amount of actual loss that occurs and is proved.

In certain cases, it may be possible to conclude that the risk transfer contract is a security-based swap or aggregation of security-based swaps. Security-based swaps are subject to a different regulatory regime than swaps. For example, the commodity pool issues discussed in this section would generally not be present for an SPE that enters into security-based swaps but not swaps. Further discussion of security-based swaps is beyond the scope of this article.

Certain commodity pool regulations remain applicable even if the CPO qualifies for exemption from registration. For example, under CFTC Regulation 4.20, a CPO must operate its pool as an entity cognizable as a legal entity separate from that of the CPO, the CPO must receive funds in the pool’s name, and the CPO may not commingle property of the pool with that of any other person.

A no-action letter is a written statement by the staff of a Division of the CFTC or its Office of the General Counsel that such staff will not recommend that the CFTC commence enforcement action for failure to comply with a specific provision of the Commodity Exchange Act or CFTC regulations. It binds only the staff of the Division that issued it or the Office of the General Counsel with respect to the specific fact situation and persons addressed by the letter, and third parties may not rely upon it. CPOs wanting to rely upon the staff letter must first meet the conditions of relief, which include filing a notice with the CFTC Division of Swap Dealer and Intermediary Oversight.


CFTC staff have addressed harmonizing this condition with the JOBS Act of 2012, which eliminated the prohibition against general solicitation in the SEC’s Regulation D and Rule 144A. See CFTC Staff Letter 14-116 (Sept. 9, 2014). The CFTC subsequently proposed a codification of this relief.


The CFTC staff stated that, if the stated notional amount of a swap is leveraged in any way or otherwise enhanced by the structure of the swap or the arrangement in which it is issued, the threshold calculation would be required to be based on the effective notional amount of the swap rather than on the stated notional amount.

In CFTC No-Action Letter 14-152, the corresponding condition utilized the definition of “highly liquid” set out in CFTC Regulation 1.25(b)(1), which states: “Investments must be ‘highly liquid’ such that they have the ability to be converted into cash within one business day without material discount in value.”

In No-Action Letter 14-111, the CFTC noted that when conducting the Notional Value Test, it was not reducing the liquidation value of the assets held by the SPE by the amount owed to the SPE’s note holders because where the SPE was required to pay coverage to a GSE due to a default event in the underlying pool of mortgages, the SPE’s obligation to repay the note holders the principal and interest on the notes was equally reduced.

In this series, we highlight a few of the regulatory considerations present in a typical CRT structured as a synthetic securitization. Parts one and two of this series discuss the primary legal considerations that may be encountered in doing a CRT in the United States, but such considerations may not apply to all structures, and a CRT may give rise to additional legal, regulatory and accounting considerations not discussed in this series. We continue our series with a look at issues that may arise under the Volcker Rule and US risk retention rules in connection with structuring CRTs in the United States.

Volcker Rule Implications
If a CRT is structured to use a special purpose entity (SPE) that issues securities, the SPE will need an exemption or exclusion from registration under the Investment Company Act of 1940, as amended (ICA).

One potential avenue is reliance on the exclusion provided by Section 3(c)(7) of the ICA, which is available for any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers (i.e., investors that meet certain thresholds for the holding of investment securities), and which is not making and does not at that time propose to make a public offering of such securities.

However, reliance on the exclusion provided by Section 3(c)(7) of the ICA can raise other structuring considerations under the Volcker Rule. The Volcker Rule defines a covered fund as including (i) an issuer that would be an investment company, as defined in the ICA, but for reliance on Section 3(c)(1) or 3(c)(7) of the ICA; and (ii) a commodity pool under Section 1a(10) of the Commodity Exchange Act (CEA) for which the commodity pool...
operator has claimed an exemption under 17 CFR 4.7 or is registered as a commodity pool operator in connection with the operation of a certain type of commodity pool.2

Why might those structuring a CRT need to consider whether the SPE is a covered fund? First, the Volcker Rule prohibits banking entities from engaging in certain transactions with covered funds, including acquiring or retaining any “ownership interest” in the covered fund as principal.3 If investors in a CRT will include banking entities subject to the Volcker Rule and a transaction makes use of an SPE that is a covered fund, it will be necessary to consider whether the terms of the instrument are such that the investors might be considered to have an ownership interest in the SPE.

Banking entities are also generally prohibited from “sponsoring”4 covered funds absent an exemption, and Section 13(f) of the Volcker Rule (often referred to as Super 23A), generally prohibits a banking entity, directly or indirectly, from entering into a “covered transaction,”5 as defined under Section 23A of the Federal Reserve Act, with a covered fund for which the banking entity or any affiliate acts as sponsor, investment manager, or investment adviser. Therefore, a banking entity that enters into a CRT that makes use of an SPE that is a covered fund, needs to consider whether its relationship with such SPE could make it a “sponsor” of the covered fund or give rise to a “covered transaction” covered by Super 23A.

The Volcker Rule excludes from the definition of a covered fund an issuer that may rely on an exclusion or exemption from the definition of “investment company” under the ICA, other than the exceptions contained in Sections 3(c)(1) and 3(c)(7) of the ICA.6 Accordingly, the lender holding the reference assets may wish to avoid analyzing the Volcker Rule implications of utilizing an SPE that is a covered fund, by relying on an exception to the ICA for such SPE other than the exceptions contained in Sections 3(c)(1) and 3(c)(7) of the ICA. Depending on the structure of a CRT, one potential exclusion from investment company status for an SPE used in a CRT may be Rule 3a-7 under the ICA, which provides an exclusion for certain issuers engaged in the business of purchasing, or otherwise acquiring, and holding eligible assets (and in activities related or incidental thereto). Among other requirements, an issuer relying on Rule 3a-7 must issue fixed-income securities or other securities which entitle their holders to receive payments that depend primarily on the cash flow from eligible assets. For purposes of Rule 3a-7, eligible assets means “financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to security holders.” As discussed below under “Considerations Raised by US Risk Retention Rules—Could a CLN Be ‘ABS’ Subject to the US Risk Retention Rules,” whether CRTs, particularly those involving the issuance of collateralized credit-linked notes (CLNs), satisfy the requirement that the issued securities entitle their holders to receive payments that depend primarily on the cash flow from eligible assets.
flows from eligible assets, is a question that raises certain interpretive issues.

Considerations Raised by US Risk Retention Rules

CRTs pose two potential issues under the US risk retention rules. First, if the underlying exposures in a CRT include assets that have been previously securitized in a transaction subject to the US Risk Retention Rules, the sponsor of the previous securitization transaction must consider whether the entry into the CRT constitutes a prohibited transfer or pledge of the interest the sponsor was required to retain in connection with the securitization transaction. Second, the entity owning the underlying exposures must consider whether the CRT involves the issuance of an asset-backed security (ABS) in a transaction in which such entity could be considered a “sponsor” subject to the US Risk Retention Rules.

US RISK RETENTION RULES: PROHIBITION ON HEDGING

The US Risk Retention Rules, which were adopted by various US federal agencies in response to the Dodd-Frank Act, generally require the sponsor of a securitization transaction (or one or more majority-owned affiliates—as defined in the US Risk Retention Rules—of the sponsor) to retain a minimum economic interest in the credit risk of the securitized assets in accordance with one of the permissible forms of risk retention described in the US Risk Retention Rules and prohibit a sponsor or any affiliate from hedging or transferring the credit risk that the sponsor is required to retain. Frequently, a bank that is interested in engaging in a CRT will already have securitized a portion of the potential reference pool in a traditional securitization that is subject to the US Risk Retention Rules, or may want the flexibility to include such assets in future securitization transactions. As a result, a bank indirectly holding reference assets subject to an on-balance sheet securitization must consider whether the CRT constitutes an impermissible hedge of its required risk retention interest in connection with the securitization transaction, which will be the case if:

1. Payments on the CRT are materially related to the credit risk of one or more particular ABS interests that the retaining sponsor (or any of its majority-owned affiliates) is required to retain with respect to a securitization transaction or one or more of the particular securitized assets that collateralize the asset-backed securities issued in the securitization transaction; and

2. The CRT in any way reduces or limits the financial exposure of the sponsor (or any of its majority-owned affiliates) to the credit risk of one or more of the particular ABS interests that the retaining sponsor (or any of its majority-owned affiliates) is required to retain with respect to a securitization transaction or one or more of the particular securitized assets that collateralize the asset-backed securities issued in the securitization transaction.
A sponsor grappling with the above analysis could consider whether the CRT may be designed to include securitized assets in a manner that still ensures that payments on the CRT do not reduce or limit the exposure of the sponsor to the credit risk it is required to retain. One potential method to do so may involve creating one or more synthetic securitization exposures that mirror the terms of the securitization exposures in the sponsor’s traditional securitization that are not required to be retained for risk retention purposes and then including only such securitization exposures in the CRT reference pool (specifically excluding the retained risk retention interest).

For potential CRT sponsors that do not currently have traditional securitizations involving the potential reference pool, such sponsors may still wish to preserve flexibility under the terms of the CRT to remove assets from the reference pool for inclusion in future traditional securitizations that are subject to the US Risk Retention Rules. Doing so may raise additional issues—for example, potential prepayment risk for investors—that may need to be considered in structuring a transaction.

**COULD A CLN BE “ABS” SUBJECT TO THE US RISK RETENTION RULES?**

Only sponsors of asset-backed securities, as defined under the Securities Exchange Act of 1934, as amended (Exchange Act), are subject to the US Risk Retention Rules. CRTs will often involve the issuance of credit-linked notes or other securities, and therefore a bank engaging in a CRT must consider whether such securities are asset-backed securities. An asset-backed security is defined in the Exchange Act as follows:

“The term ‘asset-backed security’” —

A. Means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including —

i. A collateralized mortgage obligation;

ii. A collateralized debt obligation;

iii. A collateralized bond obligation;

iv. A collateralized debt obligation of asset-backed securities;

v. A collateralized debt obligation of collateralized debt obligations; and

vi. A security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and …”

CLNs issued in a CRT are often collateralized by the cash proceeds of the issuance of the CLNs, which may be held in a trust account for the benefit of both the CRT sponsor or protection buyer (to satisfy payments on the guaranty or credit derivative) and the investors in the CLNs. As a result, there are potentially two pools of “self-liquidating financial assets” that must be considered when analyzing whether CLNs are asset-backed securities—(1) the “cash” collateral for the CLNs, which may be invested in highly-rated securities and (2) the underlying reference assets for the CRT.
Whether CLNs are collateralized by self-liquidating assets that allow the holders of the CLNs to receive payments that depend primarily on cash flow from the assets (and are therefore potentially asset-backed securities) is a challenging question. On the one hand, the assets that can best be described as “collateralizing” the CLNs are the investment securities that provide security for the CLNs and are the sole source of cash flows for the CLNs. On the other hand, the assets which most directly affect the performance of the securities—that is, which determine the amount and timing of payments of principal in respect of such securities—are the reference assets. In other words, payments on the CLNs are highly dependent on the performance of the reference pool, but the CLNs are not entitled to the cash flow from the reference pool and CLN holders do not have the benefit of a security interest in the reference pool.

Second, one might question whether a bank holding a reference pool of assets in a CRT involving the issuance of CLNs is a “sponsor”—within the meaning of the US Risk Retention Rules—of an asset-backed securities transaction. Under the US Risk Retention Rules, a “sponsor” is defined as an entity that “organizes and initiates a securitization transaction by either selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity.” Whether a putative sponsor has sold or transferred assets has taken on heightened importance in the analysis after the recent United States Court of Appeals for the District of Columbia Circuit decision holding that the US Risk Retention Rules cannot be applied to managers of open market CLOs, in which the court found that a securitizer must “actually be a transferor, relinquishing ownership or control of assets to an issuer.” While a bank that enters into a CRT necessarily must transfer all or a portion of the credit risk of the underlying exposures to third parties, the bank retains ownership of the reference assets, which would support the view that the US Risk Retention Rules are not applicable to synthetic securitizations.

Given the ambiguities discussed above, some bank sponsors may choose to comply with the US Risk Retention Rules rather than grapple with the potential interpretive issues.
Endnotes

1  Section 13 of the Bank Holding Company Act of 1956.
2  12 CFR 248.10(b)(1).
3  12 CFR 248.10(b)(1).
4  A “sponsor” would include an entity that:
   a. Acts as a general partner, managing member, trustee of a covered fund (or serves a CPO of a pool that is a covered fund due to its commodity pool status);
   b. In any manner selects or controls a majority of the directors, trustees, or management of a covered fund (including having employees, officers, directors or agents who constitute that majority); or
   c. Shares the same name, or a variation of the same name, with a covered fund for corporate, marketing, or other purposes. 12 CFR 248.10(d)(9).
5  The definition of covered transaction includes (i) loans and other extensions of credit to the covered fund; (ii) purchases of assets from and investments in securities issued by the covered fund; (iii) issuance of financial guarantees on behalf of a covered fund; (iv) securities borrowing or lending that results in a credit exposure to the covered fund; and (v) a derivatives transaction that results in credit exposure to the covered fund.
6  12 CFR 248.10(c)(12)(ii).
7  79 FR 77601 [hereinafter the “US Risk Retention Rules”]
8  § 12(a) of the US Risk Retention Rules. The US Risk Retention Rules contain certain “sunset” provisions for the hedging and transfer restrictions applicable to most ABS and RMBS, after which such restrictions will not apply.
9  Id.
11  § 2 of the US Risk Retention Rules.
13  §217.41 of Regulation Q.
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 Regulation2 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 tranch, 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. 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.

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.


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.
Endnotes

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


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”).
Mayer Brown is a distinctively global law firm, uniquely positioned to advise the world’s leading companies and financial institutions on their most complex deals and disputes. With extensive reach across four continents, we are the only integrated law firm in the world with approximately 200 lawyers in each of the world’s three largest financial centers—New York, London and Hong Kong—the backbone of the global economy. We have deep experience in high-stakes litigation and complex transactions across industry sectors, including our signature strength, the global financial services industry. Our diverse teams of lawyers are recognized by our clients as strategic partners with deep commercial instincts and a commitment to creatively anticipating their needs and delivering excellence in everything we do. Our “one-firm” culture—seamless and integrated across all practices and regions—ensures that our clients receive the best of our knowledge and experience.

Please visit mayerbrown.com for comprehensive contact information for all Mayer Brown offices.

Mayer Brown is a global services provider comprising associated legal practices that are separate entities, including Mayer Brown LLP (Illinois, USA), Mayer Brown International LLP (England), Mayer Brown (a Hong Kong partnership) and Tauil & Chequer Advogados (a Brazilian law partnership) (collectively the “Mayer Brown Practices”) and non-legal service providers, which provide consultancy services (the “Mayer Brown Consultancies”). The Mayer Brown Practices and Mayer Brown Consultancies are established in various jurisdictions and may be a legal person or a partnership. Details of the individual Mayer Brown Practices and Mayer Brown Consultancies can be found in the Legal Notices section of our website.

“Mayer Brown” and the Mayer Brown logo are the trademarks of Mayer Brown.

© 2020 Mayer Brown. All rights reserved.

Attorney Advertising. Prior results do not guarantee a similar outcome.