



REPORT

**ON STS FRAMEWORK FOR SYNTHETIC
SECURITISATION UNDER ARTICLE 45 OF
REGULATION (EU) 2017/2402**

EBA/OP/2020/07

06 MAY 2020

EBA

EUROPEAN
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Abbreviations

| | |
|----------------|--|
| ABCP | asset-backed commercial paper |
| ABS | asset-backed security |
| AT1 | additional Tier 1 capital |
| BCBS | Basel Committee on Banking Supervision |
| BRRD | Bank Recovery and Resolution Directive |
| CDO | collateralised debt obligation |
| CLN | credit linked note |
| CLO | collateralised loan obligation |
| CMBS | commercial mortgage-based security |
| CRD | Capital Requirements Directive |
| CRR | Capital Requirements Regulation |
| EBA | European Banking Authority |
| EIB | European Investment Bank |
| EIF | European Investment Fund |
| EIOPA | European Insurance and Occupational Pensions Authority |
| EMEA | Europe, the Middle East and Africa region |
| ESMA | European Securities and Markets Authority |
| EU | European Union |
| IACPM | International Association of Credit Portfolio Managers |
| IFRS 9 | International Financial Reporting Standard 9 |
| IOSCO | International Organization of Securities Commissions |
| IRB | internal ratings based |
| LGD | loss given default |
| N/A | not applicable |
| PCS | Prime Collateralised Securities |
| RMBS | residential mortgage-based security |
| RWA | risk-weighted asset |
| S&P | Standard & Poor |
| SEC-SA | securitisation standardised approach |
| SES | synthetic excess spread |

| | |
|-------------|--|
| SMEs | small and medium-sized enterprises |
| SRT | significant risk transfer |
| SSM | single supervisory mechanism |
| SSPE | securitisation special purpose entity |
| STC | simple, transparent and comparable (Basel framework) |
| STS | simple, transparent and standardised (EU framework) |
| TLAC | total loss-absorbing capacity |

1. Executive summary

This report has been developed in response to the mandate assigned to the EBA in the Securitisation Regulation (Regulation (EU) No 2017/2402), which requires the EBA — in close cooperation with ESMA and EIOPA — to develop a report on the feasibility of a framework for simple, transparent and standardised (STS) synthetic securitisation that is limited to balance-sheet securitisation. To that end, the EBA published a discussion paper on the STS framework for synthetic securitisation in September 2019 for a 2-month consultation period. This report builds on the discussion paper and the analysis of the responses received from stakeholders.

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

It examines the rationale of the STS synthetic product and assesses the positive and negative implications of its possible introduction. Based on the analysis conducted, the EBA recommends the following:

- Establish a cross-sectoral framework for STS synthetic securitisation that is limited to balance-sheet securitisation.
- To be eligible for 'STS' status, synthetic securitisation must comply with the proposed criteria on simplicity, standardisation and transparency.
- The European Commission should consider the pros and cons related to a potentially differentiated capital treatment for STS balance-sheet synthetic securitisation, and any potential future proposal for STS synthetic securitisation should be accompanied by a mandate to the EBA to monitor the functioning of the STS synthetic market.

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

A separate chapter is dedicated to the analysis of a possible differentiated regulatory treatment of STS synthetic securitisation for the consideration of the European Commission. On the one

hand, developments in the last few years have indicated the potential for the continuing growth of the synthetic sector and have confirmed the technical feasibility of the creation of a prudentially sound STS synthetic securitisation product that is comparable to the STS traditional securitisation product. In addition, the available performance data do not provide any evidence that the performance of the synthetic securitisation instrument is worse than that of the traditional securitisation instrument. The introduction of potentially limited and clearly defined differentiated regulatory treatment would match the historical performance of the synthetic securitisation, ensure better alignment with the STS traditional securitisation framework and help overcome the constraints of the current limited STS risk-weight treatment of some SME synthetic securitisations.

On the other hand, there are limitations of the performance data on which the analysis is based, there is limited experience with the STS traditional framework so far, and the risk of potentially overusing synthetic securitisation, which would potentially lead to a large-scale replacement of regulatory capital by risk mitigation strategies, leading to overleveraging of banks, should be duly taken into account. In addition, the preferential regulatory treatment is not included in the international Basel standards.

2. Background and rationale

1. Article 45 of Regulation (EU) No 2017/2402 (hereafter ‘Securitisation Regulation’) requires the EBA — in close cooperation with ESMA and EIOPA — to publish a report on the feasibility of a specific framework for STS synthetic securitisation that is limited to balance-sheet synthetic securitisation. In line with recital 24 of the Securitisation Regulation, this report also determines the respective STS criteria. Based on the EBA report, the Commission will assess whether or not to adopt a legislative proposal.

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

Recital 24

In securitisations which are not true-sale, the underlying exposures are not transferred to an issuer entity which is a SSPE, but rather the credit risk related to the underlying exposures is transferred by means of a derivative contract or guarantees. This introduces an additional counterparty credit risk and potential complexity related in particular to the content of the derivative contract. For those reasons, the STS criteria should not allow synthetic securitisation.

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

Article 45

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

2. The mandate for the development of the STS framework for synthetic securitisation has a wider background and builds on previous discussions and regulatory work on the topic.
3. First, Article 270 of Regulation (EU) No 575/2013 on capital requirements¹ already allows for the preferential regulatory treatment of synthetic securitisation on a limited basis (i.e. senior tranches of SME portfolios retained by originator credit institutions, provided that the significant credit risk has been transferred to either supranational entities — central banks, central government, multilateral development banks or international organisations — that are 0% risk weighted through unfunded guarantees or private investors through fully collateralised

¹ Regulation (EU) No 2017/2401 of the European Parliament and of the Council of 12 December 2017 amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms.

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

4. Second, this assessment builds on the **EBA Report on Synthetic Securitisation**, published in December 2015². The EBA report contains an analysis and market practice assessment of the synthetic securitisation market. In the report, the EBA proposed extending the STS framework to fully cash-funded credit protection provided by private investors (at the time of publication of the EBA report, only credit protection provided by supranational entities was eligible for STS treatment, under the Commission's proposal on the amendments to the CRR). The EBA recommendations have been reflected in the final CRR (see paragraph 3).
5. In the EBA report, the EBA also proposed amending the criteria determining the eligibility for STS preferential treatment for balance-sheet synthetic securitisation and provided detailed proposals for such amendments. These included amendments to the criteria on simplicity, transparency and standardisation for traditional securitisation and the inclusion of new synthetic securitisation-specific criteria (largely aimed at ensuring that the credit protection contract is structured in a standardised fashion, to adequately protect the position of the originator).
6. Third, the mandate follows the EBA Discussion Paper on Significant Risk Transfer in Securitisation, published in September 2017³. The EBA discussion paper put forward, for public discussion, detailed proposals to strengthen the regulation and supervision framework of SRT associated with the traditional and synthetic securitisation. In the discussion paper, the EBA proposed a number of recommendations for the harmonisation of structural features widely present in synthetic and/or traditional securitisation, including recommendations on excess spread and pro-rata amortisation. The concept of SRT is extremely relevant for both traditional and synthetic securitisation, as the achievement of the SRT is a precondition for an originator to apply the securitisation framework (whether STS or non-STS) to retained securitisation exposures and achieve capital relief. SRT is particularly important for synthetic securitisation, as the transfer of risk, and associated capital relief, is one of the key motivations for engaging in this type of securitisation.
7. The recognition of synthetic securitisation has also been the focus of **market initiatives**. For example, Prime Collateralised Securities (PCS) label, launched in early 2017, has been awarded to synthetic securitisations meeting defined criteria for a simple, transparent and standardised instrument⁴. The 'PCS Risk Transfer Label' was designed to provide a market reference standard for synthetic securitisations, similar to the 'PCS True Sale Label', which was introduced in 2012 and has been applied to traditional securitisations.

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

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

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

8. Finally, the EBA published a discussion paper on the STS framework for synthetic securitisation in September 2019 for a 2-month consultation period. Most of the responses from stakeholders expressed strong support both for the analysis of the synthetic securitisation market and for the rationale for the development of an STS framework for synthetic securitisation provided in the discussion paper, and there was a clear request from all stakeholders for the introduction of a preferential capital treatment of the STS synthetic securitisation, in the belief that the impact of STS synthetic securitisations would be limited if no differentiated capital treatment were introduced.

Figure 2: STS treatment of synthetic securitisation in the CRR

Article 270: Senior positions in SME securitisations

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

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

3. Creation of an STS synthetic securitisation market

3.1 Introduction

Rationale for the development of an STS framework for traditional securitisation

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

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

12. Regulatory recognition has so far been focused on traditional securitisation and not on synthetic securitisation. Synthetic securitisation remains outside the scope of the STS/STC reforms that recognise the simplicity, transparency and standardisation of the securitisation, i.e. it has been assigned the regulatory capital treatment of non-STC securitisation, foreseen by the Basel 2014 revision of the securitisation framework (globally) and non-STC securitisation set out in the amended CRR (in EU). At this stage, therefore, no European or global standards exist to identify a subset of synthetic securitisation products as simple, standard/comparable and transparent products.
13. With respect to traditional securitisation, the STS framework for traditional securitisation was proposed by the EBA in the EBA report published in July 2015⁶, and was subsequently adopted and implemented by both the international and the EU regulatory community. The Basel STC framework for term securitisation was adopted in July 2016 and entered into force in January 2018, while the STC framework for short-term securitisation was adopted in May 2018 and entered into force immediately thereafter. In the EU, the STS framework has been implemented through the EU securitisation framework (composed of the Securitisation Regulation and the amendments to the CRR), which entered into force on 1 January 2018 and became applicable on 1 January 2019.

Rationale for a limited focus on synthetic securitisation so far

14. There have been several reasons for the enhanced focus of regulatory recognition on traditional securitisations. First, detailed data have been made available on the historical credit performance of the traditional securitisation market that confirmed the good performance of the EU securitisation market during the pre-crisis period (e.g. according to the EBA Report on Qualifying Securitisation, EMEA RMBS and ABS products displayed almost zero losses over the period 2000-2013). Second, traditional securitisation has played an important role in the financial markets as a channel for diversifying funding sources, distributing financial-sector risk and helping to free up originators' balance sheet for further lending on the economy. The STS framework was a way for the regulatory community to acknowledge the positive implications that a sound traditional securitisation can have for the financial stability and the funding of the real economy.
15. In the same vein, there are several reasons for the, so far, conservative approach to synthetic securitisation taken by regulators. One of the core considerations is a lack of systematic and publicly available data on market developments, volume and the historical performance of synthetic securitisation and different asset classes in Europe. This is because the synthetic deals during the post-crisis period were mostly bilateral and therefore almost entirely private, with very little information publicly available.
16. The data available on synthetic securitisation at that time show that different types of synthetic securitisations performed differently, with respect to both structural types of synthetic

⁶ EBA Report on Qualifying Securitisation:
https://eba.europa.eu/documents/10180/950548/EBA+report+on+qualifying+securitisation.pdf_

securitisation and different asset classes. First, there is clear evidence that arbitrage synthetics performed materially worse than balance-sheet securitisations. In the past, arbitrage synthetic transactions were structured to be complex and highly dependent on market values and performed poorly in terms of historical defaults. However, synthetic transactions that have been genuinely used by institutions to transfer the credit risk from their lending activity off-balance sheet, i.e. balance-sheet synthetics, have performed relatively well. Second, there is wider evidence for zero defaults in relation to highly rated synthetic tranches of SME exposures, although information on other asset classes is less conclusive. Nevertheless, data available from rating agencies suggest that the default performance of balance-sheet synthetics is comparable to that of traditional securitisation for high rating grades and even better for lower rating grades.

17. In addition, the market of synthetic securitisation, to a much larger extent than that of true sale securitisation, has traditionally been characterised by issuance of bespoke transactions, i.e. it has been largely non-standardised. In particular, the credit protection mechanism, which is the core of a synthetic securitisation transaction and constitutes the structural element of difference with respect to true sale transactions, has been implemented in accordance with a wide spectrum of practices and was perceived at the time to increase the structural complexity because of the additional counterparty credit risk of the protection seller.
18. The lack of systematic data at that time, analysis available at that time and, as a consequence, the lack of sufficient evidence or information on the feasibility of standardising the synthetic structure similarly as for traditional securitisations did not support the development of the fully fledged STS framework for synthetics across different asset types. Instead, regulatory recognition focused on limiting the scope of the qualifying treatment to senior positions retained by the originator banks and SME exposures. At that stage, however, it was clear that arbitrage synthetics should be excluded from the STS framework, and any potential STS framework should be limited to balance-sheet synthetics.

3.2 Market developments and trends

3.2.1 Data sources

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

- a. data from market participants and rating agencies, in particular:
 - i. data on the **volume of balance-sheet synthetic securitisation transactions, and investor base**, from 2008 to early 2019 — the data were collected during an exercise conducted by the IACPM in the first quarter of 2019; they include responses provided by 22 banks that are most active in the synthetic securitisation market in Europe and cover 244 balance-sheet securitisation transactions;
 - ii. **with respect to the historical performance of synthetic securitisation**, data from three sources: (1) data on the historical performance of balance-sheet synthetics, gathered through a data-gathering exercise coordinated by the IACPM and covering 70 transactions executed by 14 banks (the data cover the period from 2008 to early 2019, i.e. they are representative of the post-crisis period); (2) data from Standard & Poor (S&P) on the historical performance of balance-sheet synthetics, covering in total 5 948 synthetic securitisation tranches of rated synthetic transactions in Europe (although the data also cover the period from 2008, a substantial majority of tranches were rated pre-crisis, and these data are therefore mostly representative of the pre-crisis period); and (3) data from a large pension fund and one of the largest investors in balance-sheet securitisations on the historical performance of all their transactions entered into since 2006;
- b. data from the reporting by competent authorities on synthetic transactions that achieved SRT and therefore had to be notified to the EBA, in line with the EBA SRT Guidelines, from 2015 to the first quarter of 2019;
- c. information gathered through an industry roundtable organised by the EBA in March 2019 and other qualitative market analysis.

3.2.2 Market developments

Volume and size of the market

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

21. The 2008 financial crisis marked the crash of the securitisation market, after which, also owing to the stigma attached to the synthetic segment, the securitisation market gradually emerged, particularly in the traditional (and retained) form. With respect to synthetic securitisation, following a few years of subdued issuance, the synthetic market has been recovering in recent years, with both the number and the volume of transactions steadily increasing. While larger transactions, originated by the protection buyer, have been concentrated in a few jurisdictions (in particular, the UK, Germany, Spain, France and Italy), transactions have also been seen across many other EU Member States, particularly as a result of the activities of the EIF/EIB. Based on the data collection conducted by the IACPM, altogether 244 balance-sheet synthetic securitisations were issued between 2008 and the end of 2018. In 2018, 49 transactions were initiated, with a total volume of EUR 105 billion.

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

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

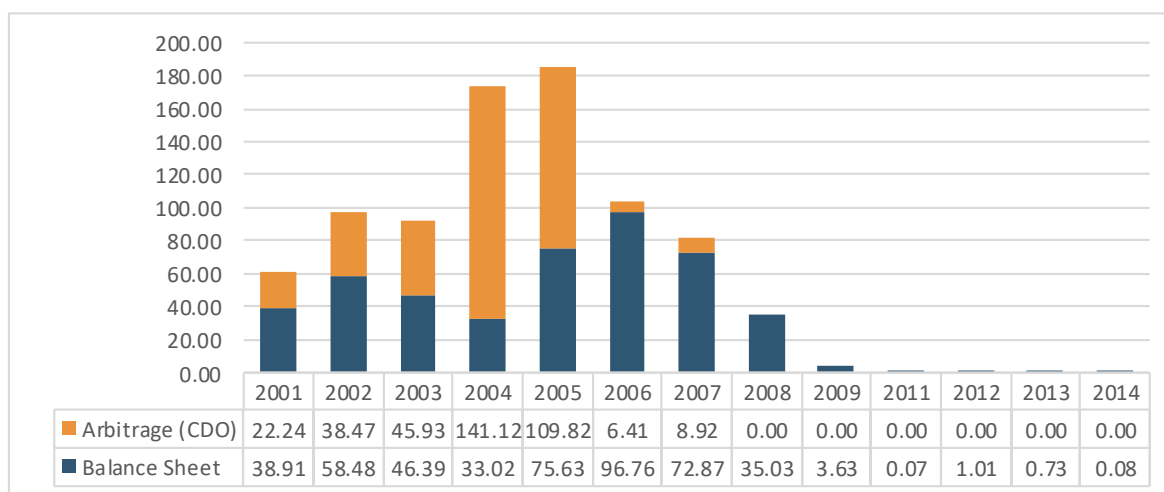
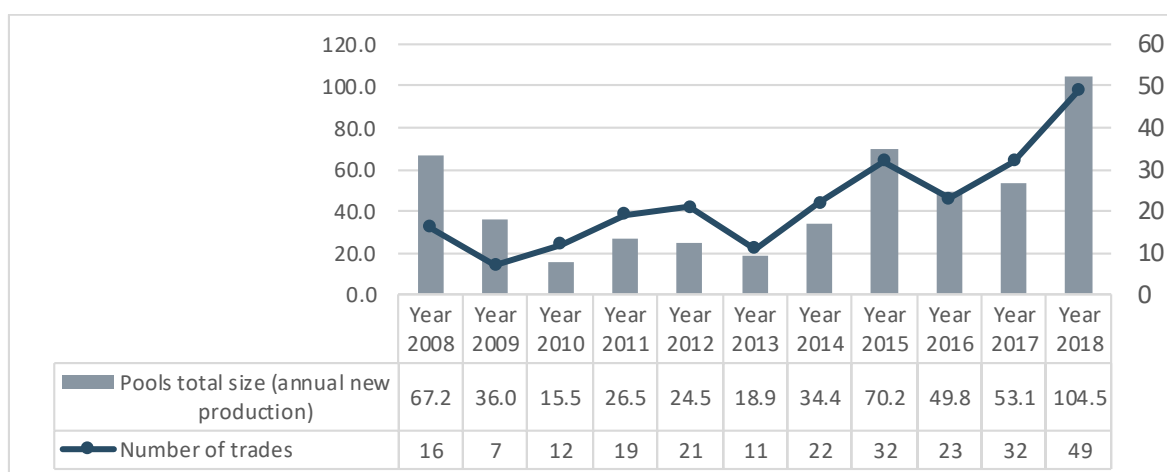


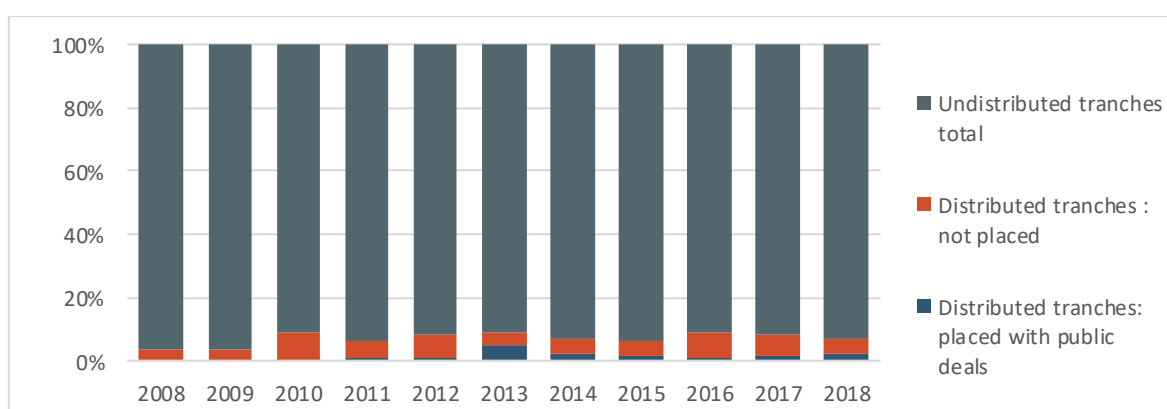
Figure 4: European balance-sheet securitisation issuance, post-crisis (size on the left axis in EUR billion; source: IACPM)



Private/public transactions

23. In contrast to the pre-crisis period, when a substantial proportion of synthetic securitisation transactions were public and rated (e.g. the 'Promise and Provide' programmes in Germany, the Bistro deals by JPMorgan), since the financial crisis a significant majority of deals have been executed privately/bilaterally and placed with a small number of investors. Credit rating agencies have rarely been involved and transactions have rarely been publicly rated, which has also been due to additional costs for originators and additional conditions on portfolio composition and transaction structures. Based on the data from the IACPM covering transactions from 2008 to 2018, 18.6% of distributed tranches of all transactions were placed publicly, which represents only 1.55% of the total proportion of the transactions.

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



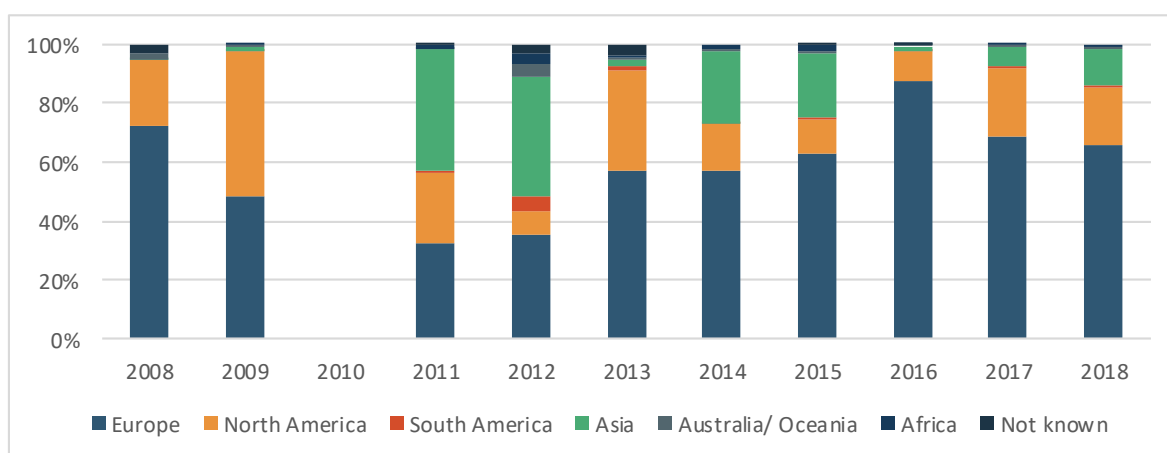
| Year/distributed tranches (in EUR million) | Undistributed tranches total size | Distributed tranches total size (not placed) | Distributed tranches (placed with public deals) | Distributed tranches placed with public deals (percentage of distributed tranches) | Distributed tranches placed with public deals (percentage of total size of the transactions) |
|--|-----------------------------------|--|---|--|--|
| Year 2008 | 64 925 | 2 229 | 0 | 0.0 | 0.00 |
| Year 2009 | 34 632 | 1 340 | 0 | 0.0 | 0.00 |
| Year 2010 | 14 148 | 1 314 | 78 | 5.6 | 0.55 |

| Year/distributed tranches (in EUR million) | Undistributed tranches total size | Distributed tranches total size (not placed) | Distributed tranches (placed with public deals) | Distributed tranches placed with public deals (percentage of distributed tranches) | Distributed tranches placed with public deals (percentage of total size of the transactions) |
|--|-----------------------------------|--|---|--|--|
| Year 2011 | 24 923 | 1 328 | 276 | 17.2 | 1.11 |
| Year 2012 | 22 562 | 1 732 | 221 | 11.3 | 0.98 |
| Year 2013 | 17 228 | 802 | 894 | 52.7 | 5.19 |
| Year 2014 | 32 031 | 1 639 | 702 | 30.0 | 2.19 |
| Year 2015 | 65 601 | 3 382 | 1 226 | 26.6 | 1.87 |
| Year 2016 | 45 442 | 3 727 | 5 868 | 13.6 | 1.29 |
| Year 2017 | 48 738 | 3 647 | 700 | 16.1 | 1.44 |
| Year 2018 | 96 975 | 5 137 | 2 417 | 32.0 | 2.49 |
| Max value: | | | | 52.7 | 5.19 |
| Average: | | | | 18.6 | 1.55 |

Geographical distribution of exposures

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

Figure 6: Weighted average geographical breakdown (as a percentage of each pool's total size, covering 244 synthetic transactions; source: IACPM)⁷



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

⁷ Data for 2010 are not available.

26. This confirms a specific nature of synthetic securitisation, namely that it is inherently easier to execute on multi-jurisdictional portfolios, giving it a comparative advantage over traditional securitisation, and also presents important differences vis-à-vis traditional securitisation (arising from, inter alia, legal complexities associated with the true sale/transfer of underlying exposures subject to different legal regimes, client confidentiality issues present in traditional securitisations and other factors).

Placed risk

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

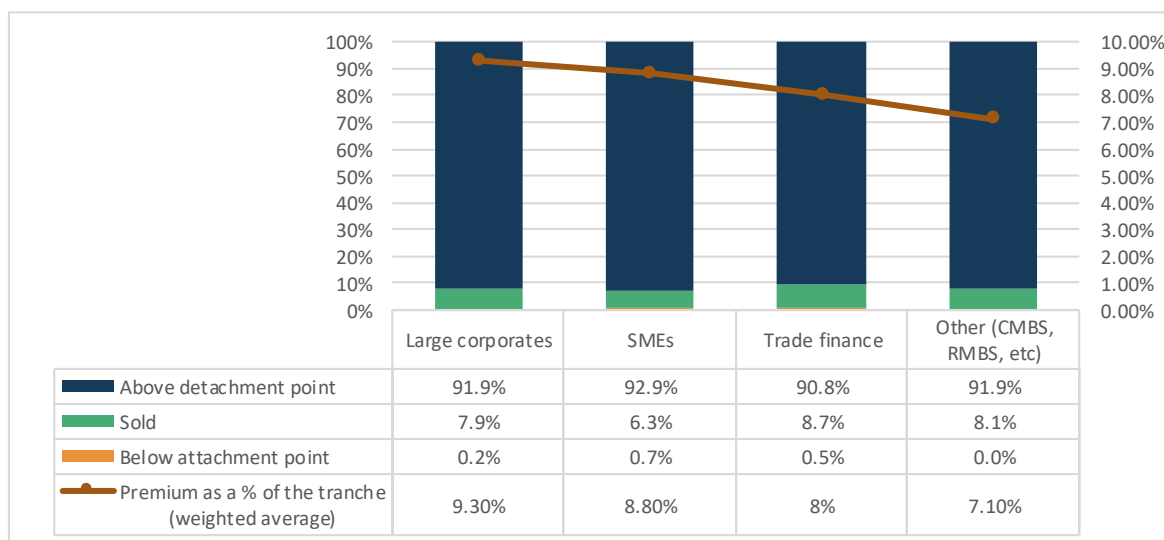
28. This is in contrast to the pre-crisis period, when originators typically placed the super senior tranches of synthetic transactions (and hence the largest tranches of the transaction in terms of volumes) with monoline insurers and/or highly rated investor institutions to, inter alia, smooth the expected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

29. Following the crisis, originators changed their involvement in the synthetic securitisation market, placing, as far as possible, only mezzanine/first loss tranches with investors. This is a reflection of various factors, such as materially different funding, the macro-economic and regulatory environment and changes in the investor base (withdrawal of monoline insurers and other relevant parties from the market). It has been observed that this reflects the change in motivation to engage in synthetics: regulatory capital management is no longer the sole motivation (other credit risk and balance-sheet management considerations are becoming important determinants under the current macro-economic environment) and changes to the regulatory framework allow banks to hedge the tail risk and free up credit lines that may be used for further lending.

30. Given that, under the current rules of the EU securitisation framework, which started to fully apply once the transitional period was over (from January 2020), and which increase (and almost double) the capital charges for senior tranches, it is not clear whether this trend (i.e. placing first loss/mezzanine risk) will persist or will change further in such a way that the originators may consider placing senior risk, in addition to mezzanine and junior risk (this expectation is under the alternative of no capital benefits for the senior tranche). It should be noted that the junior tranches, in response to the new Securitisation Regulation, have become thicker, and some new investors are entering the market.

⁸ Based on an average of 47 transactions (IACPM).

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



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

Originators (protection buyers)

32. Originators of synthetic securitisation are mostly credit institutions, in particular large/systemically important banks using internal rating-based models for calculating capital requirements for credit risk. Banks applying standardised approaches to credit risk are rarely originators of synthetic securitisations. This is mainly due to reluctance to enter a largely unstandardised/bilateral market without prior experience, as well as challenges related to accessing portfolio data and reporting and transaction costs⁹. However, recently some standardised banks have entered into synthetic transactions, in response to support given by the EIB/EIF in the context of the EIB/EIF's European SME initiatives and in response to the introduction of the SEC-SA risk weight approach under the new EU securitisation framework.

33. The analysis reveals a number of factors that contribute to the growth of the synthetic market on the originator side. For originators, having another credit risk management tool and being able to release capital have traditionally been the central benefits of a balance-sheet synthetic securitisation. Synthetic securitisation as a credit risk and balance-sheet management tool for banks remains relevant in the current operating environment; also due to recent regulatory

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

developments that enhance requirements for banks' balance-sheet management. These include, in particular, the following regulatory developments: (i) the Basel III framework approved in December 2017 and applicable from 2022, including strengthened capital requirements, revisions to the leverage ratio and the introduction of the output floor; (ii) requirements under accounting reform IFRS 9; (iii) exposure management requirements; and (iv) changes in the context of the Fundamental Review of the Trading Book. These changes may lead, on the one hand, to increased demand by banks for equity and equity linked or TLAC instruments and, on the other hand, to increased focus by banks on better balance-sheet management through the available credit management tools.

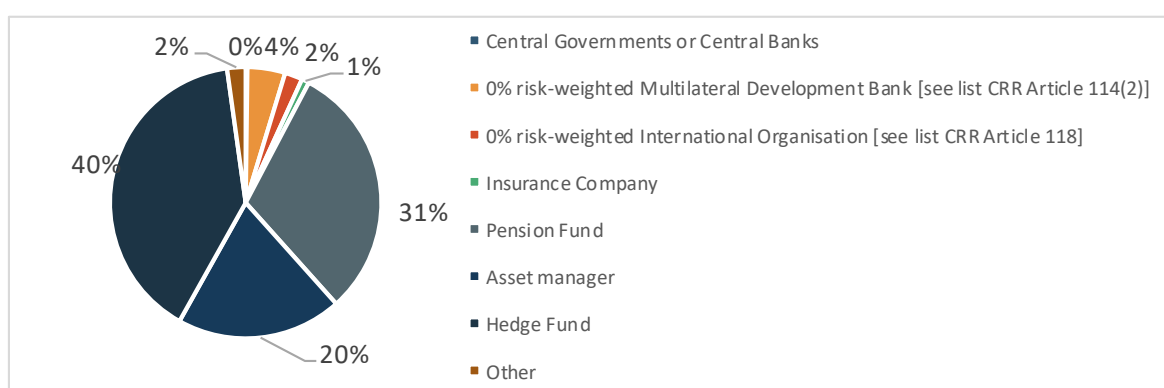
Investors (protection sellers)

34. A substantial majority of investors in synthetic securitisation are non-bank private entities, which are usually highly specialised in credit investing and experienced in portfolio due diligence. The main motivation for investors to invest in synthetic securitisation is the search for a higher yield and enhanced diversification of their investments.
35. With respect to the private investors, they mostly include hedge funds (39.6% in terms of volume of distributed tranches over the period 2008-2019), pension funds (30.6%) and asset managers (19.7%). Insurance companies form only a minority of the investor base (less than 1%). Overall, 90% of the credit protection provided by the private investors is funded credit protection. Credit institutions enter the current market of synthetic securitisation as originators and not as investors.
36. With respect to public investors, 4.5% of them are 0% risk-weighted multilateral development banks. This includes the EIB/EIF, which continue to be an important investor dominating the SME synthetic market. Under the European Commission's investment plan for Europe (the 'Juncker Plan'), the EIB/EIF have played an important role in providing credit protection to banks, with the mandate to promote lending to SMEs and reuse the freed-up capital in new SME lending.
37. In the last two years, there has been an increase in the share of public investors (in particular 0% risk-weighted multilateral development banks) and hedge funds and a decrease in the share of pension funds. Other recent trends from anecdotal evidence suggest the diversification of the investor base (with some trades involving family offices and delegated funds), as well as a growing investor base. The trends indicate the potential for further expansion of the investor base, including the involvement of new asset classes (e.g. infrastructure loans, commercial real estate loans, globally or regionally diversified corporate portfolios), which may attract new investors specialising and prioritising such assets.

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

| Type of investor | 2008-2017 | 2008-2019 |
|---|-------------|-------------|
| Public investor | 1.1% | 6.8% |
| A. Central governments or central banks | 0.2% | 0.2% |

| Type of investor | 2008-2017 | 2008-2019 |
|---|--------------|--------------|
| B. 0% risk-weighted multilateral development bank (see list in the CRR, Article 114(2)) | 0.6% | 4.5% |
| C. 0% risk-weighted international organisation (see list in the CRR, Article 118) | 0.3% | 2.1% |
| Private investor (and no guarantee from A or B) | 98.9% | 92.9% |
| D. Insurance company | 0.2% | 0.9% |
| E. Pension fund | 40.1% | 30.6% |
| F. Asset manager | 15.1% | 19.7% |
| G. Hedge fund | 33.3% | 39.6% |
| H. Other | 2.8% | 2.2% |
| Part of private investor that is funded | 89.7% | 90.1% |



Asset classes

38. The predominant asset classes continue to be large corporates and SMEs, followed by trade finance. This indicates that balance-sheet synthetic securitisation is used more for the transfer of corporate credit risk from banks to markets than for traditional securitisation. The securitisation of SMEs has also been spurred by the mandate of the EIB/EIF. In general, the securitised assets are primarily RWA-intensive assets that allow the objectives of risk transfer and capital relief to be better achieved.

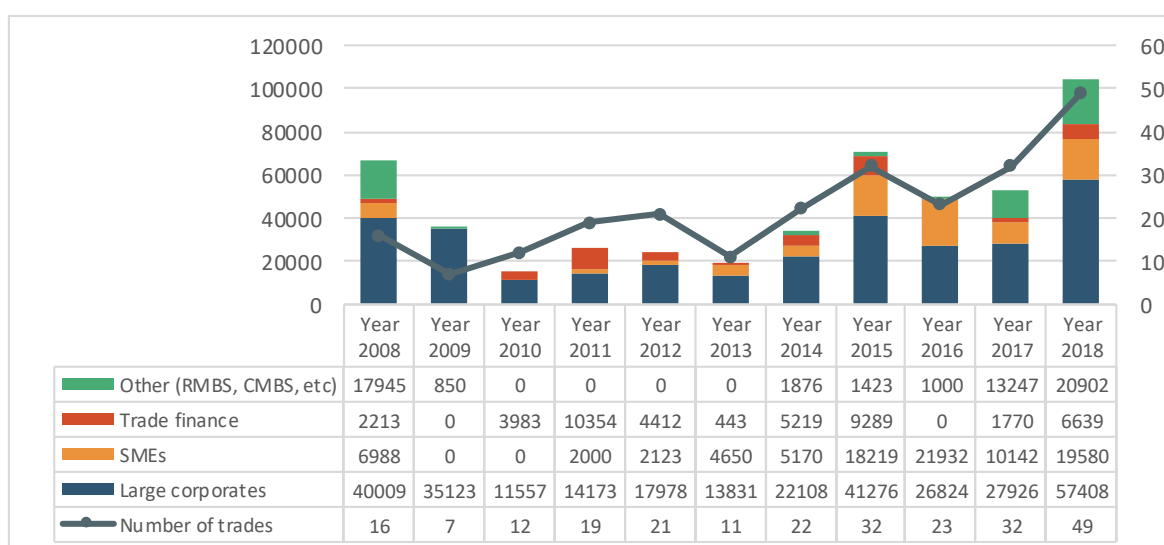
39. There has been a trend in the diversification of the asset classes, which now also include specialised lending (including infrastructure loans), commercial real estate, residential real estate, trade receivables, auto loans, micro loans and farming loans. The weighted average life of the transactions is 35 months.

40. Securitised assets also tend to be assets that are core to the bank business, which reflects, on the one hand, originators' interest in balance-sheet management and, on the other hand, investors' demands for better alignments of interest. Consequently, it is not common to see synthetic securitisation from stressed or distressed institutions, or synthetic securitisations of non-performing loan portfolios (which are mostly securitised under the traditional securitisation structure through true sale). None of the securitised transactions reported by the IACPM contained non-performing portfolios.

41. Retail exposures, such as RMBS and consumer loans, are less common in synthetic securitisation. They are securitised mostly for funding and not for credit risk management, for various reasons, including the fact that they have relatively lower risk weights. They also have internal ratings and are more prone to being subject to concentration limits of the banks; they are therefore more appropriate for traditional securitisation.

42. Going forward, we expect changes in the asset classes in the light of the regulatory capital requirements (including the output floor), which will decrease the credit risk transfer benefits for SME loans and increase the capital benefits for specialised lending and consumer/retail exposures. It is also expected that there may be an increase in multi-jurisdictional and/or multi-asset class portfolio trades.

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



Characteristics that have changed compared with the pre-crisis period

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

- a. While the majority of the transactions in the pre-crisis period were arbitrage transactions, after the crisis the European market was formed almost exclusively by balance-sheet transactions.
- b. In contrast to the pre-crisis period when a substantial proportion of synthetic securitisation transactions were public and rated, since the financial crisis the deals have mostly been executed privately/bilaterally, without any involvement of the credit rating agencies.
- c. With regard to originators' involvement, whereas, before the crisis, originators used to place super senior tranches (typically the largest tranches of a transaction in terms of volume), after

the transition from Basel I and Basel II, they started placing only mezzanine or mezzanine/first loss (smaller) tranches.

d. With regard to the credit protection mechanism used, unfunded credit protection was the prevalent credit protection mechanism applied before the financial crisis, whereas funded protection became the dominant mechanism after the crisis.

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

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

Additional data from SRT notifications

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

45. Since the entry into force of the guidelines in July 2014, altogether 142 SRT transactions have been notified by five competent authorities (European Central Bank, Greece, Italy, Sweden, UK), with a total notional value of EUR 199 billion. In the case of SSM, the notifications are related to transactions of significant institutions covering various jurisdictions.

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

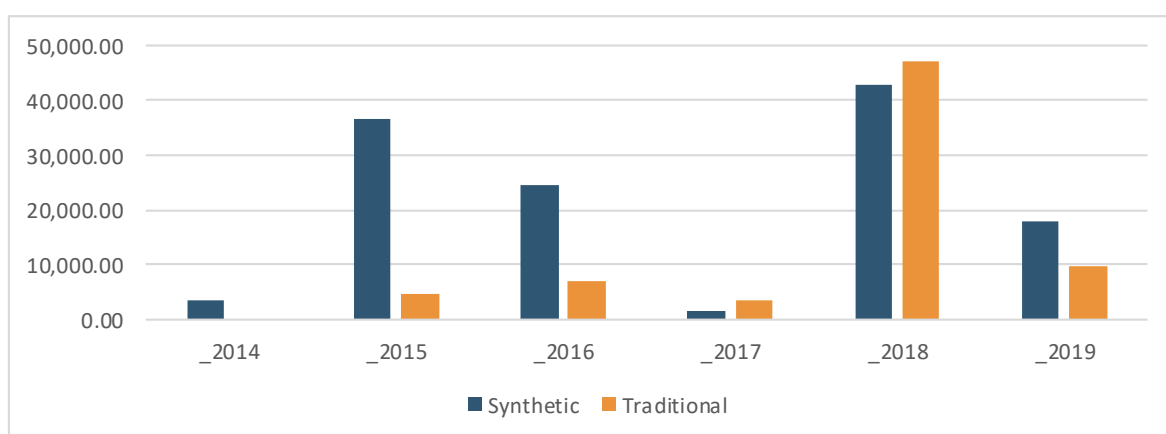
| | 2014 | 2015 | 2016 | 2017 | 2018 | Q1 2019 | Total |
|-------------------------------|----------|-----------|-----------|----------|-----------|-----------|------------|
| Number of transactions | 3 | 20 | 25 | 6 | 60 | 28 | 142 |
| Synthetic transactions | 3 | 17 | 17 | 3 | 35 | 20 | 95 |

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

| | 2014 | 2015 | 2016 | 2017 | 2018 | Q1 2019 | Total |
|---|-----------------|------------------|------------------|-----------------|------------------|------------------|-------------------|
| Traditional transactions | 0 | 3 | 8 | 3 | 25 | 8 | 47 |
| Total notional value (EUR million) | 3 328.50 | 41 363.60 | 31 326.80 | 5 400.80 | 90 028.30 | 27 446.30 | 198 894.30 |
| Synthetic transactions (EUR million) | 3 328.50 | 36 579.10 | 24 485.00 | 1736.7 | 42 765.10 | 17 791.10 | 126 685.50 |
| Traditional transactions (EUR million) | | 4 784.50 | 6 841.90 | 3664 | 47 263.20 | 9655.3 | 72 208.80 |

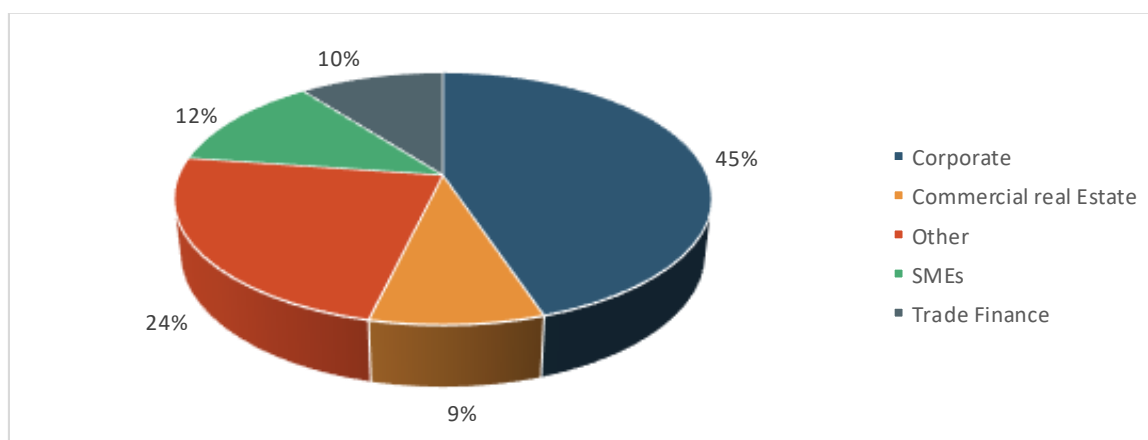
46. Synthetic securitisations represent a significant majority of the SRT transactions: 95 out of 142 transactions were synthetic, with the total notional value amounting to EUR 126 billion (63.7% of the total notional value of all reported transactions).

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



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

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



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

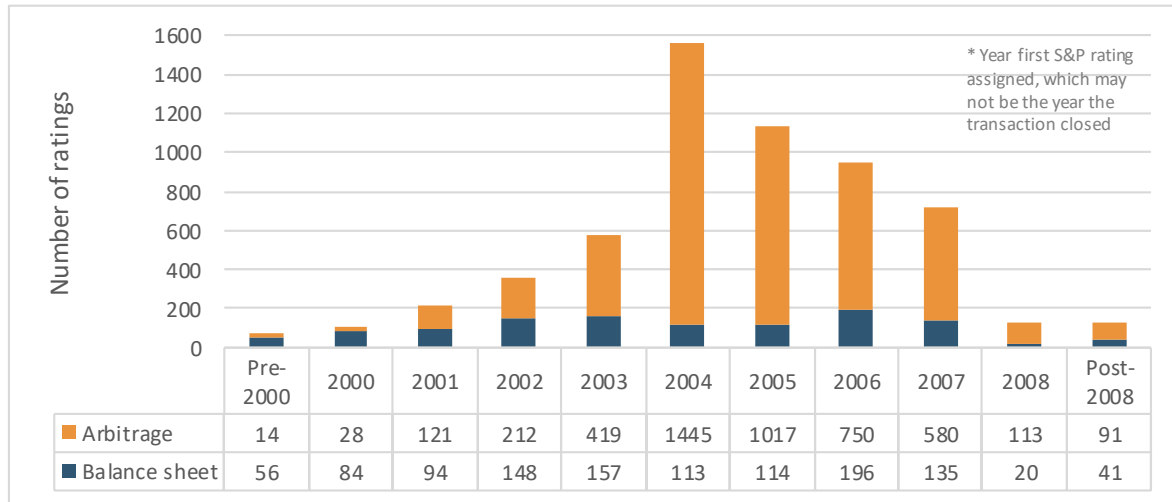
¹¹ 'Other' includes residential mortgages (3), leasing receivables (1), consumer loans (10), social housing (1), mixed asset types and other collateral (6).

3.2.3 Historical performance

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

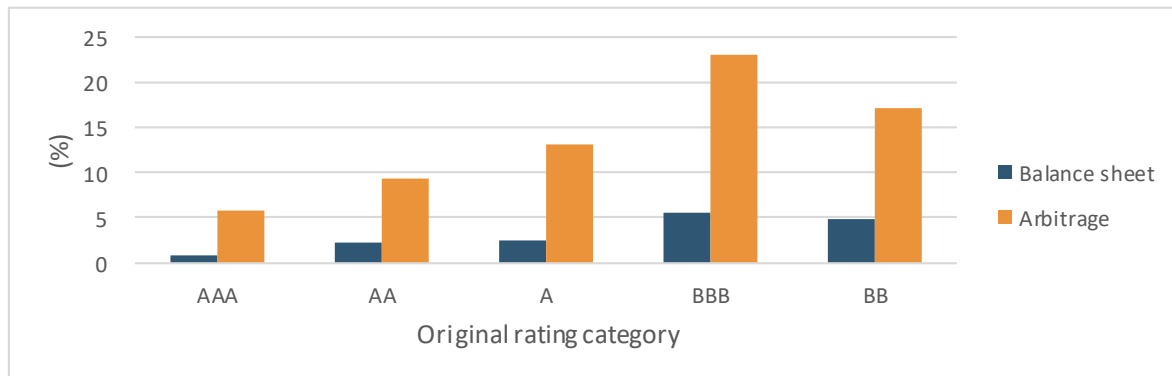
49. The S&P data indicate that, in the pre-crisis period, 80.1% of ratings (in terms of number) were arbitrage securitisations.

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



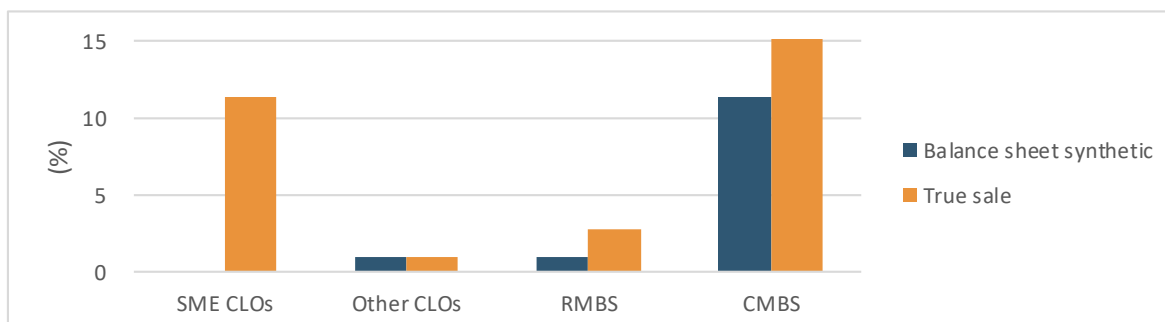
50. The arbitrage synthetics have performed materially worse than balance-sheet transactions.

Figure 15: Lifetime default rate for synthetic tranches (as of the end of 2018; source: S&P)



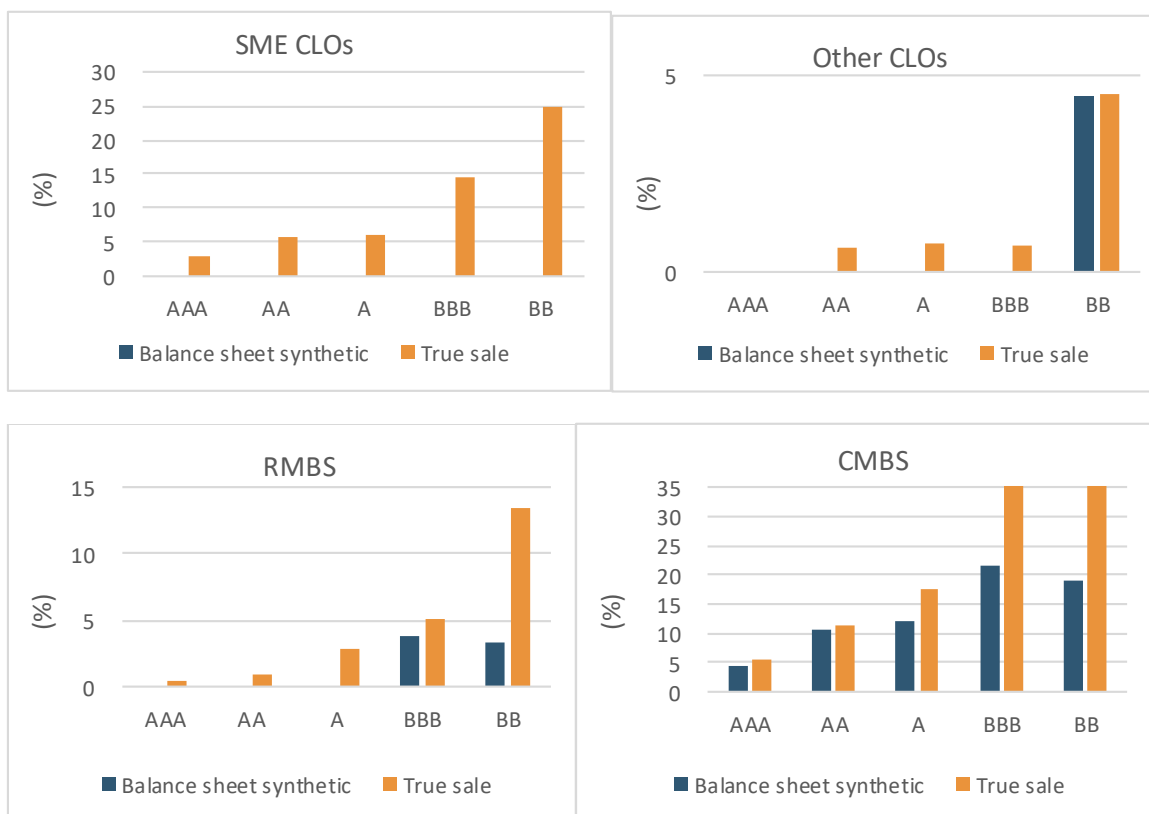
51. Balance-sheet synthetics have performed better than traditional securitisations, for all asset classes (SME CLOs, RMBS, CMBS and other CLOs).

Figure 16: Lifetime default rates, selected asset classes (as of the end of 2018)



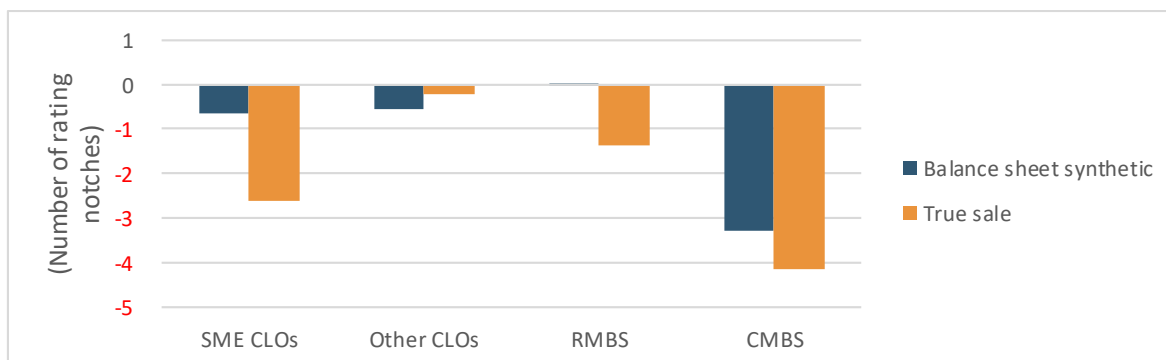
52. The same applies to all the rating grades. The default performance of balance-sheet synthetics is better than that of the traditional securitisations, for all selected asset classes (as of the end of 2018).

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



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

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



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

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

55. The data from S&P suggest that, from a methodological perspective, there is no evidence that would support an *ex ante* expectation of worse performance of the synthetic securitisation instrument, as opposed to the traditional securitisation instrument, once the other risk drivers mentioned are accounted for.

56. The data from the IACPM show that there are zero default and loss rates on senior tranche, for the significant majority of reported transactions and asset classes. This one exception is SMEs, among which the average annual default rate on 21 reported transactions is 0.11%, and the annual loss rate 0.02%. In any case, the maximum annual default rate for individual transactions is 1.6%. The good performance of senior tranches may be a consequence of various factors,

including the originator's continued servicing of the underlying exposures and the application of eligibility criteria during the selection process of the underlying exposures.

Figure 19: Cumulative observed defaulted amount and loss amount at 31 December 2018 on the senior tranche divided by senior tranche size at inception and divided by number of years elapsed (to measure realised annual default rate and realised annual loss rate; source: IACPM)

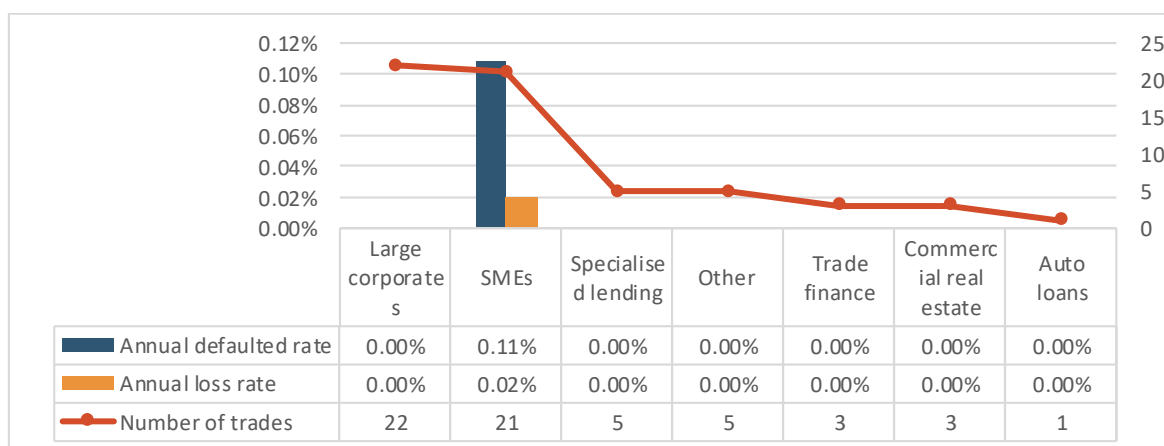
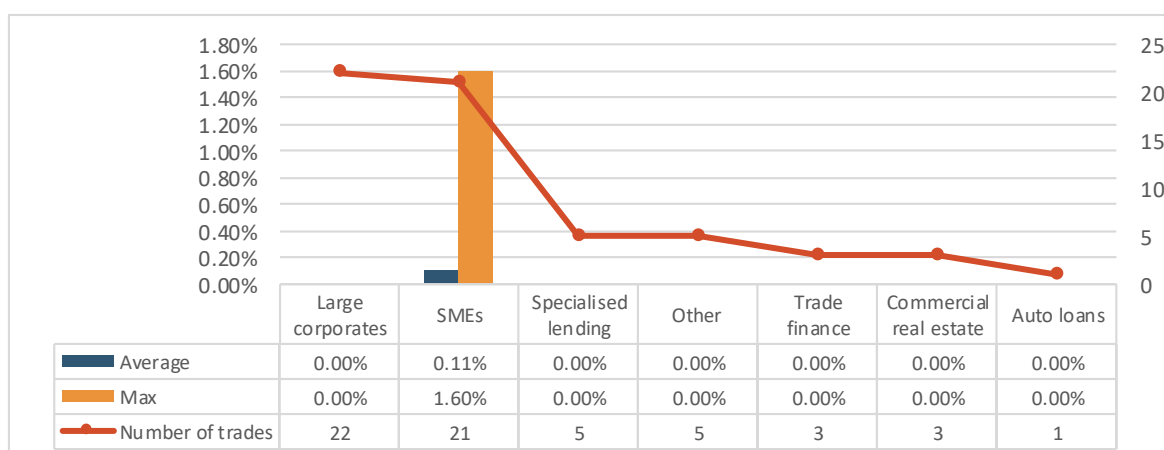


Figure 20: Realised annual default rate for senior tranche: average and maximum



57. The default and loss rates are slightly higher when considering the whole portfolio (i.e. all tranches and not senior tranches only). The default and loss rates are highest for SMEs, followed by specialised lending¹². The average annual default rate for SMEs is 0.59%, while the maximum reported amount is 1.77%. With respect to average annual default rates for other asset classes, the value is in every case below 1%.

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

Figure 21: Cumulative observed defaulted amount and loss amount at 31 December.2018 on the securitised portfolio divided by trade size at inception and divided by number of years elapsed (to measure realised annual default rate and realised annual loss rate; source: IACPM)

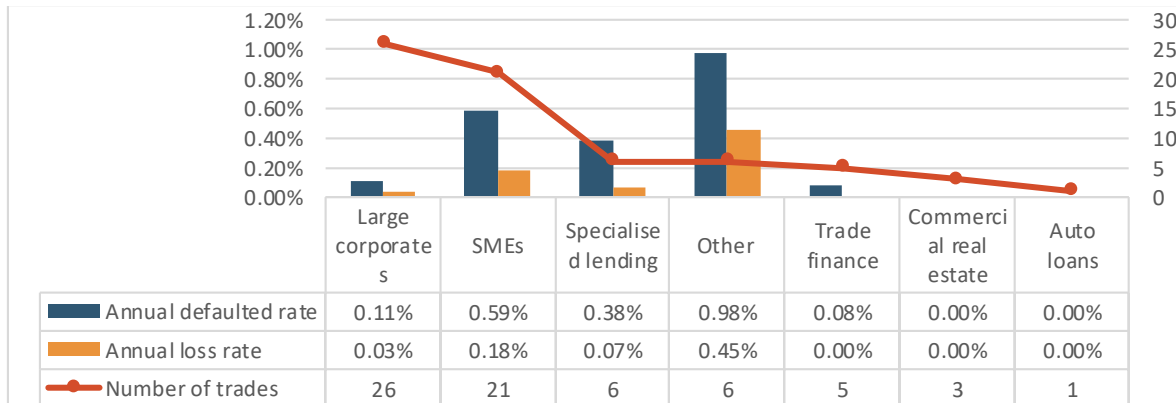
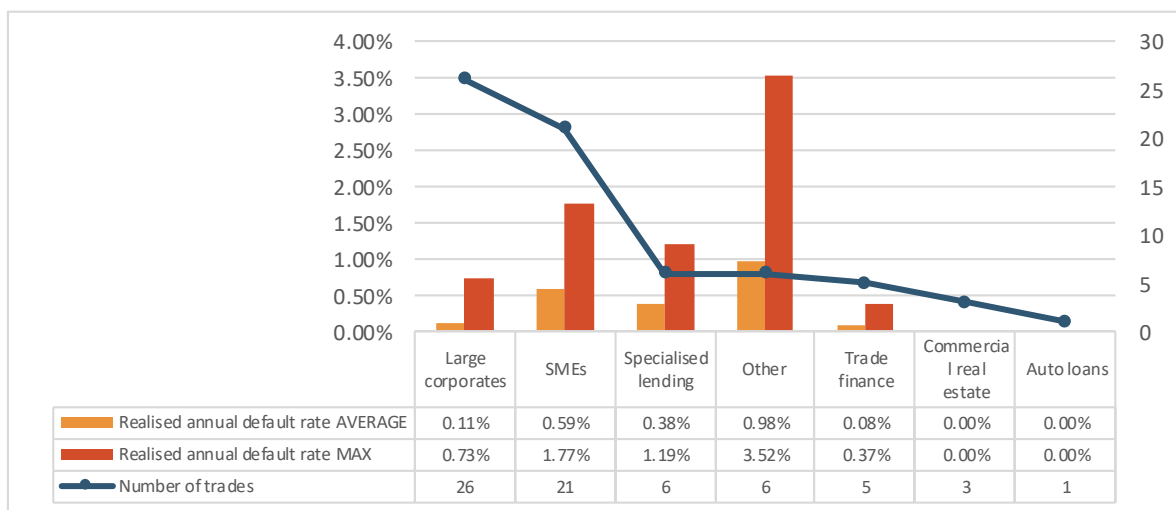


Figure 22: Realised annual default rate: average and maximum (source: IACPM)



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

Figure 23: Default rate: realised annual default rate, realised annual default rate on senior tranche and observed annual default rate on a comparable but broader portfolio of the bank, at 31 December 2018 (e.g. from the same business division or using the same rating model as the securitised pool; source: IACPM)

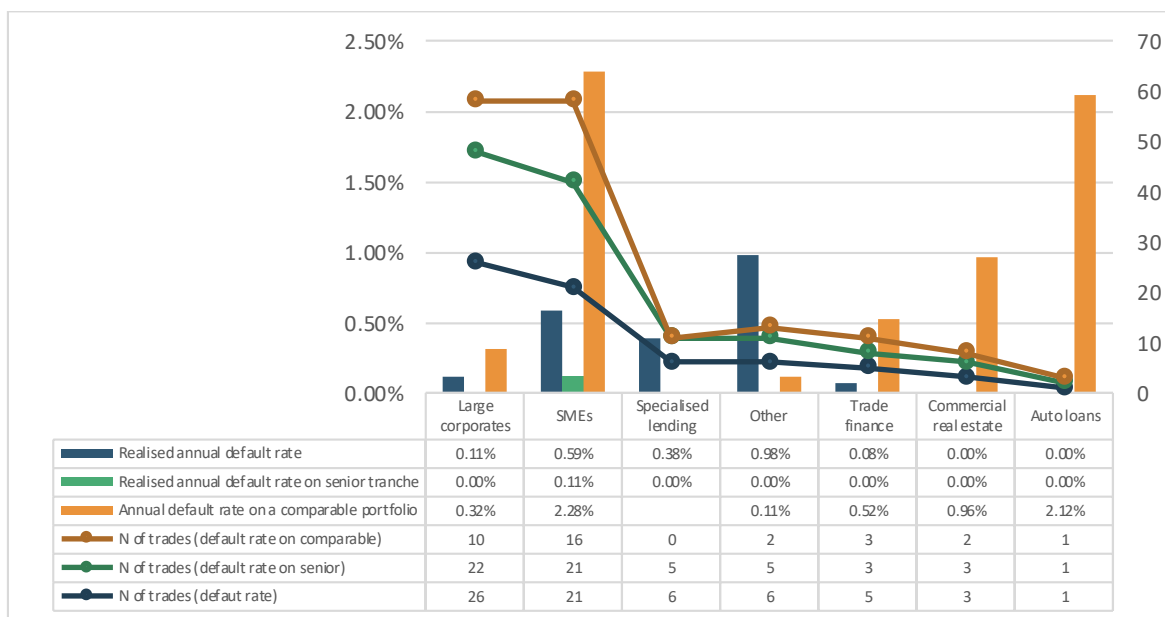
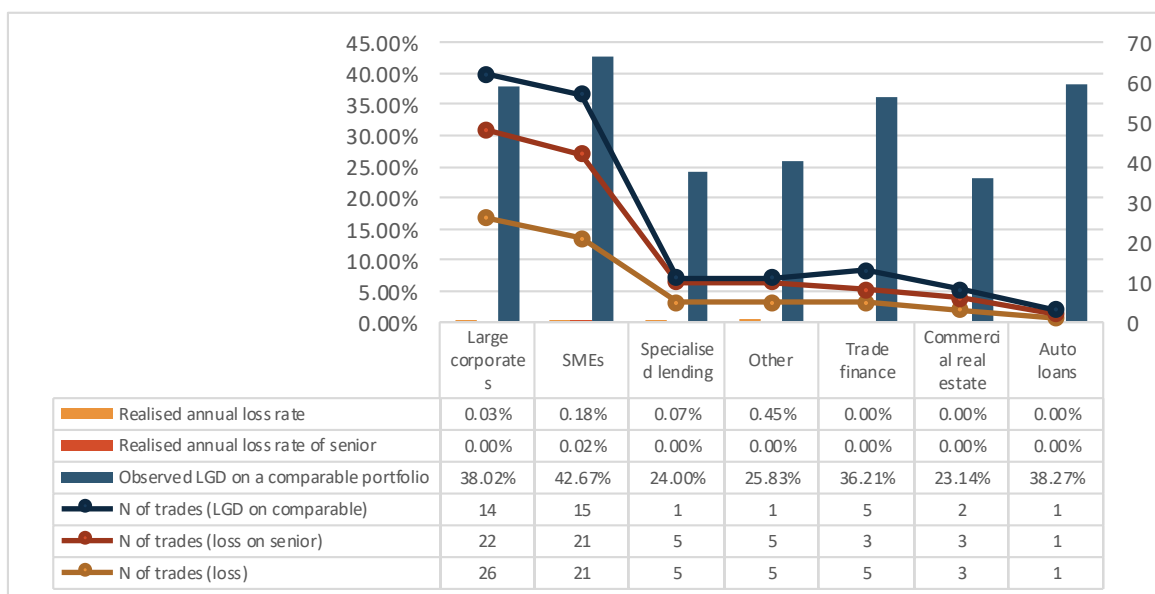


Figure 24: Loss rate: realised annual loss rate, realised annual loss rate on senior tranche and observed LGD on a comparable but broader portfolio of a bank



59. When interpreting the data, data limitations, particularly the following, should be taken into account:

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

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

60. In addition, the data from a large pension fund and a major investor in the European synthetic market indicate the good performance of the transactions in which the pension fund invested, which shows low default rates in general and zero default rates suffered by the originator on the senior tranches (originators never suffered a loss on any of the transactions they invested in, i.e. 44 trades since 2006).

3.3 Rationale

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

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

3.3.1 Changing the regulatory and market environment

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

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

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

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

67. In addition, the quantity of available data on synthetic securitisation will increase even more in the immediate future, in the context of the enhanced transparency requirements under the Securitisation Regulation. The transparency requirements and the standardised disclosure templates developed by ESMA are applicable to both traditional and synthetic securitisation, and provide very detailed information on underlying exposures as well as the securitisation structure and counterparties. Public securitisations must complete all templates, while private securitisations are required to comply with the underlying exposure templates only. Although, in the case of private transactions, the disclosure templates will not be published and made publicly available in the securitisation repositories, the disclosure templates will still need to be used bilaterally between parties to the deal and may be accessed by both the supervisors and the European supervisory authorities.

68. Third, the evidence available on the recent and ongoing market trends increases the relevance of the potential STS framework. The observed market practices indicate a trend towards increasing standardisation in the synthetic market as well as a growing appetite for the harmonisation of this market segment. One of the major incentives in recent months has been the publication, in September 2017, of the EBA Discussion Paper on the Significant Risk Transfer in Securitisation¹³, which has stimulated debate and discussion in the synthetic securitisation market. The EBA proposals put forward in the discussion paper, both on the structural features of the transactions and on the amount/quantitative features of the transferred risk, have affected transactions in the market and have also had impact on the assessment of SRT by some competent authorities. This indicates that there is scope for further standardisation of the structural features of the synthetic securitisation. This has also been noticeable in the market responses to the discussion paper, in which two common themes have been observed: (i) a strong preference for harmonisation and a level playing field; and (ii) a desire to ensure that any rules are workable and effective for the market.

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

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

3.3.2 Specificities of synthetic and traditional securitisation

71. While synthetic securitisation and traditional (i.e. 'true sale') securitisation may not fundamentally differ in terms of the nature of the underlying exposures, risk tranching and capital (waterfall) structures, there is an important difference between the ways of transferring risk from the originator to the investor. While traditional securitisation realises this transfer by

¹³ <https://eba.europa.eu/regulation-and-policy/securitisation-and-covered-bonds/discussion-paper-on-the-significant-risk-transfer-in-securitisation>.

transferring the actual underlying exposures as well as their ownership to an SSPE, synthetic securitisation realises the risk transfer by means of a credit protection contract between the originator and the investor, leaving the underlying exposures in the ownership of the originator and on its balance sheet.

72. In synthetic securitisation, therefore, the actual extent of risk transfer depends not only on the capital structure of the transaction (i.e. the tranching) and potential mechanisms of support from the originator (as is the case in traditional securitisation) but also on the features of the credit protection contract on which the originator and investor agree and on the creditworthiness of the investor.

73. An inherent aspect of the transfer of credit risk of the exposures that remain on the originator's balance sheet is that the parties in synthetic securitisation are 'communicating vessels', in contrast to traditional securitisation, in which, because of the true sale, the originator transfers both the risk and ownership of the exposures to the SPV, and the links between the originator and the investor are therefore less relevant. Therefore, while the regulation of traditional securitisation (including the STS framework) is mostly focused on the protection of the investor, in the case of synthetic securitisation the regulation (and any potential amendment to the STS framework) should focus on both the originator and the investor. Mitigating the risks involved in synthetic securitisation is thus as important for the originator's positions as it is for the investor's positions. In synthetic securitisation, different contractual features can potentially result in very different degrees of protection for the originator and the investor. In particular, in a context in which both the originator and the investor in a synthetic transaction are credit institutions, different contractual features can significantly bias the credit protection arrangement towards a prudentially stronger, SRT process for the originator and against the investor, or vice versa.

74. There are also different motivations for entering into traditional or synthetic securitisation. Synthetic securitisation has emerged as a useful tool for a large number of banks in their credit risk and capital management activities, as it enables them to transfer credit risk to the private capital markets efficiently, thus freeing up both capital and lending limits and allowing them to continue lending activities. In this regard, synthetic securitisation serves a different purpose to traditional securitisation, which is more commonly used as a funding tool rather than as a credit risk management tool.

75. Synthetic securitisation also tends to be easier to execute than traditional securitisation. Originators may be incentivised to use synthetic rather than traditional securitisation owing to the greater flexibility of the synthetic mechanism, which is cheaper in terms of costs and quicker to arrange. It also allows the originator to avoid the legal and operational difficulties that can arise in a true sale transaction related to the transfer of ownership of the underlying exposures. Synthetic securitisation also allows originators to address confidentiality issues related to, for example, the obligors' identity or commercial secrets. Compared with traditional securitisation, it is therefore also easier to mix asset classes and exposures from different jurisdictions, to increase the diversification and granularity of the portfolio.

76. From a regulatory/supervisory perspective, compared with traditional securitisation, synthetic 'balance-sheet' securitisation exposes the investor (protection provider) to the pure credit risk of the underlying exposures. In particular, risks stemming from the cash flow profile of the securitisation, such as pre-payment risk and interest risk, are less relevant to the investor's position, as the cash flows from the underlying exposures are not passed on to investors (i.e. they are not used to pay the premium/guarantee fee payments owed to the investors). In addition, the legal risks relating to the transfer of ownership and the segregation of the underlying exposures (claw-back risk, etc.) are not applicable within the synthetic securitisation environment.
77. The counterparty credit risk potentially arising in the credit protection contract is the only element of complexity, from a transaction structure perspective, that is specific to synthetic securitisation. Counterparty credit risk may arise for the originator of the transaction (the protection buyer) because of the risk of default (or other events) in relation to the investor (the protection seller), resulting in a lack of credit protection. Counterparty credit risk may also arise for the investor (protection seller) because of the risk of default (or other events) in relation to the originator, resulting in missed premium/fee payments by the originator and, if applicable, the loss of collateral posted by the investor to the originator or to a third party to fund the credit protection.
78. Any STS framework would therefore need to be adapted to the specificities of the synthetic securitisation, particularly with respect to different specific risks (such as counterparty credit risk), the specificities of the credit transfer and different motivations for both originators and investors to engage in the synthetic securitisation.

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

79. The assessment of the STS framework for synthetics should include two separate discussions:
- a. first, a discussion on the 'first stage', i.e. the possibility of developing an STS synthetic product, namely a product that would be able to meet the 'qualifying' criteria, thus ensuring simplicity, standardisation and transparency, as well as specific criteria for synthetic securitisation, capturing all main risk drivers not related to the underlying exposures;
 - b. second, a separate discussion on the 'second stage', i.e. the potentially more risk-sensitive regulatory treatment of such an STS product.
80. These discussions should be perceived as separate, i.e. it may be possible to develop a framework for an STS synthetic product without introducing a more risk-sensitive regulatory treatment of this instrument.
81. As a starting point, both analyses acknowledge the technical feasibility of creating an STS product, i.e. they take into account the fact that the structure of synthetic securitisation allows the structure of traditional securitisation to be replicated, including that of STS traditional securitisation, in terms of mitigating the main drivers of risk, such as agency and model risks that

are not linked to underlying exposures. As a result, it is acknowledged that the synthetic structure allows the performance of synthetic securitisation to be aligned with the performance of traditional securitisation of the same asset class, and that, from a technical perspective, there is no evidence that would suggest that the synthetic securitisation structure inherently results in losses that are higher than those of the traditional securitisation structure.

3.3.4 Pros and cons of the development of an STS synthetic product

82. The STS synthetic framework has not been developed at global level (IOSCO/BCBS). The existing Basel STC framework covers only traditional securitisation and does not extend to synthetic securitisation. An STS framework for synthetic securitisation could thus lead to a super-equivalent regime, with additional operational issues for originators and investors.

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

| Pros | Cons |
|--|---|
| Increased transparency of the product | Could be perceived as a high-quality label by less sophisticated market players |
| Increasing relevance of the product in the context of ongoing regulatory developments | Could lead to less issuance of traditional STS securitisations |
| Increased relevance of the product resulting from some advantages compared with traditional securitisation | |
| Further standardisation of the product and opening of the market for smaller originators and investors | |
| Importance of regulatory endorsement for the revival of the market | |
| Potential positive impact on the financial and capital markets, financial stability and the real economy | |

Pros

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

85. *Increasing relevance of the product in the context of current regulatory developments:* The relevance and attractiveness of synthetic securitisation as a credit risk and balance-sheet management tool remains relevant in a more complex operating environment; this is in part due to recent regulatory developments that enhance requirements for banks' balance-sheet

management. These include, in particular, the following regulatory developments: (i) the Basel III framework, approved in December 2017 and applicable from 2022, including strengthened capital requirements, revisions to the leverage ratio and introduction of the output floor; (ii) requirements under accounting reform IFRS9; (iii) exposure management requirements; and (iv) changes in the context of the Fundamental Review of the Trading Book. These changes may lead, on the one hand, to increased demand by banks for equity and equity-linked or TLAC instruments and, on the other hand, increased focus by banks on a better balance-sheet management through the available credit management tools.

86. Increased relevance of the product due to some advantages, compared with traditional securitisation: As mentioned above, synthetic securitisation provides more flexibility than traditional securitisation and helps to overcome administrative, legal and operational constraints involved in traditional securitisation, particularly in the case of the true sale mechanism. It allows a greater spectrum of exposures to be securitised and capital to be freed up more quickly. This is especially relevant to the securitisation of SME loans. It also facilitates the securitisation of types of exposures that are not suitable for traditional securitisation (e.g. loans with transfer restrictions, such as larger corporate loans or loans to borrowers in jurisdictions where it is impossible to achieve an effective true sale).

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

88. Importance of regulatory endorsement for the revival of the market: Feedback from a number of stakeholders indicates that regulatory endorsement of the synthetic product going hand in hand with harmonisation and standardisation is of crucial importance for the originators for the destigmatisation, economic viability and revival of the market. It would stimulate more banks to issue synthetics, and this in turn would increase the investor base.

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

a. The synthetic securitisation provides a second pair of eyes for analysis of the pool: to the extent that the pool of performing exposures is representative of a bank's overall exposure in that area, the fact that the bank is able to execute a deal indicates that the underwriting quality and the bank's systems and processes stand up to the due diligence of an investor.

- b. If soundly structured, the synthetic securitisation can provide a risk diversification tool for the banks, it can be used as an instrument for the hedging of tail risk in economic downturn, and it can enable the risk transfer from banks to non-bank entities and hence facilitate the allocation of risk more widely within the Union financial system.
- c. The synthetic securitisation has notable potential to free up originators' balance sheets, to allow for further lending to the economy. This may be relevant for the revival of SME lending.

Cons

90. The introduction of an STS synthetic product may have potential negative consequences, such as potential confusion of the market with a two-layer structure (STS/non-STS versus traditional/synthetic) and increased risk of moral hazard due to the perception (among less sophisticated market players) that the STS label inherently means a high-quality product.
91. It could also lead to less issuance of traditional STS securitisations (although, given the different objectives of the traditional and synthetic securitisations, no materially significant impact on traditional securitisation is expected through the introduction of an STS synthetic product) or to further STS developments later on, such as developments in STS non-performing loan securitisations.

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

92. The analysis below provides an assessment of the 'second stage' of the STS framework, i.e. the potential differentiated regulatory treatment of such an STS product.

| Pros | Cons |
|--|--|
| Stimulation of the development of an STS product; more in line with the actual performance of balance-sheet synthetics, more risk-sensitive regulatory framework | No preferential treatment for STS synthetic securitisation has been developed at global level (IOSCO/BCBS) |
| Overcoming constraints of the current limited STS risk-weight treatment of SME synthetic securitisations | Potential increased risks for the banking sector in the case of material exposures to STS synthetic |
| Ensuring more regulatory alignment with the traditional securitisation | Limited experience with STS traditional framework |
| Positive impact of the synthetic securitisation on the financial markets and stability | Potential overuse of synthetic securitisation |

Pros

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

94. *Overcoming constraints of the current limited STS risk-weight treatment of SME synthetic securitisations:* The practicability of the provisions on STS treatment of synthetic securitisation of SME portfolios in Article 270 of the CRR is limited. The synthetic securitisation needs to meet the STS criteria that have been specifically designed for traditional securitisation and are difficult to apply to synthetic products without further interpretation or clarification of the STS traditional criteria, as specified in this report.
95. *Ensuring more regulatory alignment:* The development of a two-stage STS framework for synthetics would ensure greater regulatory alignment with similar treatment of the traditional securitisation.
96. *Positive impact of the synthetic securitisation on the financial markets and stability:* The regulatory recognition of the STS product, and an expected increase in demand and issuance, would further enhance the potential positive impacts of the synthetic securitisation. For example, the banks' lending capacity would be increased, more capital could be freed up for further lending to the economy, and more risk would be transferred to be spread across the financial system. Furthermore, STS is also an investor protection standard and will enhance the quality and transparency of the product for all stakeholders involved, including investors and supervisors, without jeopardising the financial stability if the regulatory capital benefit is restricted to the senior tranche of the protection buyer only.

Cons

97. *Not included in the Basel standards:* One of the main deficiencies of the STS framework for synthetics is that it is not envisaged in the Basel standard. The existing Basel STC framework covers only traditional securitisation and does not extend to synthetic securitisation. It is also unlikely that this framework — in particular the more risk-sensitive regulatory treatment — will be developed in the future, taking into account the fact that no consensus has been reached among Basel members, including the United States. However, the deviations from the Basel standards are not without precedence (for example, the EU extends more favourable treatment to covered bonds than the Basel standards).
98. *Potential risks for the banking sector:* The introduction of lower capital requirements for banks may increase the opportunistic behaviour of banks and the motivation for banks to engage in securitisation for capital benefits. This could lead to the introduction into the originator's balance sheet of excessive leverage that is inherent in synthetic securitisation and could potentially have a negative impact on the stability of the bank.
99. *Limited experience with STS traditional framework:* It should also be considered that there is currently a lack of practical experience with the STS traditional securitisation framework, which entered into force in January 2019 and has not yet been fully implemented. It may be argued that some experience should be gathered with the functioning of the STS traditional framework, before establishing any preferential regulatory treatment for a possible STS framework for synthetics, which may be considered too early at this stage.

100. *Potential over-use of synthetic securitisation:* Introduction of a differentiated capital treatment for STS synthetic securitisations could lead to a potential over-use of synthetic securitisation and provide the incentive to a potential large-scale substitution of regulatory capital by risk mitigation strategies (i.e. RWA reductions) by banks which could result in banks' increased leverage if not properly monitored and supervised.

3.4 Criteria for STS synthetic securitisation

3.4.1 Introduction

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

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

a.that the overall complexity and riskiness of the securitisation structure are appropriately mitigated;

b.that the introduction of an STS framework for synthetic securitisation should not avert the incentives of an originator when adopting a certain securitisation technique (e.g. it should not incentivise the originator to securitise, in a synthetic format, the exposures that, owing to specific features of riskiness, are not eligible under the STS framework for traditional securitisation).

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

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

a.A set of criteria for STS traditional securitisation that is not workable in synthetic securitisation transactions owing to inherent differences from the traditional technique has been eliminated or adapted, for example the criterion of no embedded maturity transformation has been deleted as the underlying assets are not sold to an SPPE and therefore there is no re-financing risk in a synthetic securitisation.

b.A set of new criteria, specific to synthetic securitisation, have been introduced:

- i. Ensure that the STS framework only targets balance-sheet synthetic securitisation, as opposed to arbitrage securitisation.
- ii. Ensure that the credit protection agreement is structured to adequately protect the position of both the originator and the investor from a prudential perspective.
- iii. Address counterparty credit risk for both the originator and the investor. It is important that synthetic transactions also adequately mitigate the counterparty credit risk incurred by the originator, to adequately mimic comparable traditional securitisation positions when such a risk does not arise.

105. Figure 26 provides an overview of the STS criteria and a comparison with the STS criteria for traditional securitisation.

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

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

| | | |
|---|--|---|
| | Criterion 10: Originator's expertise | Similar to the criterion on originator's expertise [Art. 20(10)] |
| | Criterion 11: No defaulted exposures or exposures subject to outstanding disputes | Similar to the criterion on no defaulted exposures [Art. 20(11)] |
| | Criterion 12: At least one payment made | Similar to the criterion on at least one payment made [Art. 20(12)] |
| Standardisation | Criterion 13: Risk retention requirements | Similar to the criterion on risk retention requirements [Art. 21(1)] |
| | Criterion 14: Appropriate mitigation of interest rate and currency risks | Adaptation of the criterion on appropriate mitigation of interest rate and currency risks [Art. 21(2)]: to further specify measures for appropriate mitigation of interest rate and currency risks, adapted to synthetic securitisation |
| | Criterion 15: Referenced interest payments | Similar to the criterion on referenced interest payments [Art. 21(3)] |
| | Criterion 16: Requirements after enforcement/acceleration notice | Adaptation of the criterion on requirements after enforcement/acceleration notice [Art. 21(4)]: adapted to reflect the fact that not all synthetic securitisations use SSPE |
| | Criterion 17: Allocation of losses and amortisation of tranches | Adaptation of the criterion on requirements for non-sequential priority of payments [Art. 21(5)]: adapted with additional requirements for pro rata amortisation and allocation of losses |
| | Criterion 18: Early amortisation provisions/triggers for termination of the revolving period | Adaptation of the criterion on early amortisation provisions/triggers for termination of the revolving period [Art. 21(6)]: adapted with requirements for early amortisation only in the case of the use of an SSPE |
| | Criterion 19: Transaction documentation | Adaptation of the criterion on transaction documentation [Art. 21(7)]: with additional requirements for servicing standards and procedures |
| | Criterion 20: Servicer's expertise | Similar to the criterion on servicer's expertise [Art. 21(8)] |
| | Criterion 21: Reference register | Replacement of the criterion on definitions, remedies in the transaction documentation [Art. 21(9)]: requirements for the transaction documentation to specify payment conditions is covered in separate criteria |
| | Criterion 22: Timely resolution of conflicts between investors | Similar to the criterion on timely resolution of conflicts between investors [Art. 21(10)] |
| Transparency | Criterion 23: Data on historical default and loss performance | Similar to the criterion on data on historical default and loss performance [Art. 22(1)] |
| | Criterion 24: External verification of the sample | Similar to the criterion on external verification of the sample [Art. 22(2)] |
| | Criterion 25: Liability cash flow model | Similar to the criterion on liability cash flow model [Art. 22(3)] |
| | Criterion 26: Environmental performance of assets | Similar to the criterion on environmental performance of assets [Art. 22(4)] |
| | Criterion 27: Compliance with transparency requirements | Similar to the criterion on compliance with transparency requirements [Art. 22(5)] |
| Requirements specific to synthetic securitisations | Criterion 28: Credit events | N/A |
| | Criterion 29: Credit protection payments | N/A |
| | Criterion 30: Credit protection payments following the close out/final settlement at the final | N/A |

| | | |
|--|---|-----|
| | legal maturity of the credit protection agreement | |
| | Criterion 31: Credit protection premiums | N/A |
| | Criterion 32: Verification agent | N/A |
| | Criterion 33: Early termination events | N/A |
| | Criterion 34: Excess spread | N/A |
| | Criterion 35: Eligible credit protection agreement, counterparties and collateral | N/A |

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

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

108. For the avoidance of doubt and any misunderstandings, the proposed STS criteria for balance-sheet synthetic (both the criteria compared with traditional STS and the individual criteria) are developed for STS synthetic transactions only. The EBA does not recommend any changes to the non-STS synthetic regulatory framework for securitisation.

3.4.2 Simplicity criteria

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

Content of the criterion

General requirements for balance-sheet securitisation

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

1. The securitisation should be a **synthetic securitisation**, as defined in Article 2(10) of the Securitisation Regulation.
2. The protection buyer under the credit protection arrangements establishing synthetic securitisation is **an EU-regulated entity subject to authorisation/licensing regime that is established in the Union** and is an **originator** with respect to the underlying exposures, as defined in Article 2(3) of the Securitisation Regulation.
3. When the protection buyer is an originator with respect to the underlying exposures, as defined in point (b) of Article 2(3) of the Securitisation Regulation, i.e. the exposures underlying the synthetic securitisation have been purchased from a third party before they are securitised, the originator should apply to the purchased exposures credit and collection policies workout policies and servicing policies that are no less stringent than those that the originator applies to similar exposures that have not been purchased.
4. The underlying exposures are part of the **core lending or any other core business activity of the protection buyer**.
5. The underlying exposures should be **held on the balance sheet of the protection buyer** (or a member of the same corporate group as the protection buyer), at or before the closing date.
6. The protection buyer should undertake in the securitisation documentation **not to further hedge** its exposure to the credit risk of the underlying exposures beyond the credit protection obtained through the synthetic securitisation in a manner that results in the double hedging of the same credit risk.

Credit risk mitigation rules

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

Rationale for the criterion

The objective of the criterion is to set out requirements for balance-sheet synthetic transactions, i.e. those transactions in which the regulated institution's primary objective is the transfer of credit risk of exposures that the regulated institution itself holds on its balance sheet. The ultimate object of credit risk transfer should be exposures originated or purchased by an institution within a core lending/business activity of such regulated institutions and held on its balance sheet (or regulatory balance sheet, in the case of prudentially regulated institutions) at the closing date. In order to ensure alignment with the traditional STS framework, the protection buyer needs to be an EU established entity.

This criterion should exclude arbitrage securitisations, i.e. transactions in which the protection buyer purchases exposures outside their core lending/business activity, for the sole purpose of writing credit protection on them (i.e. securitising them) and arbitraging on the yields resulting from the transaction. Ensuring that the management of exposures purchased for the purpose of securitising them is consistent with that of similar exposures not securitised is important to

avoid the occurrence of moral hazard behaviours by the protection buyer that could result in an overall lesser credit quality of the securitisation transaction, ultimately affecting both retained securitisation positions and securitisation positions placed with investors.

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

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

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

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

Content of the criterion:

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

- **Title to and accounting of the exposures:** If the protection buyer is a credit institution or an insurance company, either the protection buyer or a member of the same corporate group as the protection buyer has full right, good and valid title to the underlying exposures and their associated ancillary rights and accounts for the credit risk of the underlying exposures in the regulatory balance sheet. If the protection buyer is not a credit institution or an insurance company, the protection buyer or a member of the same corporate group as the protection buyer has full right, good and valid title to the underlying exposures and their associated ancillary rights.
- **Compliance of the exposures with all eligibility criteria set out in the securitisation documentation:** On the date it is included in the securitised portfolio, each underlying exposure complies with all eligibility criteria and any other conditions, other than a credit event, for a protection payment in accordance with the credit protection agreement within the securitisation documentation.

- **Financing agreements' validity and enforceability:** To the best of the protection buyer's knowledge, the contractual agreement for each underlying exposure contains a legal, valid, binding and enforceable obligation of the obligor to pay the sums of money specified in it.
- **Underwriting standards:** The underlying exposures meet the standard underwriting criteria and these are no less stringent than the underwriting criteria that the originator applies to similar exposures that are not securitised.
- **No obligor default or other material breach:** To the best of the protection buyer's knowledge, on the date it is included in the securitised portfolio, none of the obligors with respect to each underlying exposure are in material breach or default of any of their obligations in respect of that underlying exposure.
- **No untrue information:** To the best of the protection buyer's knowledge, there is no untrue information on the particulars of the underlying exposures contained in the securitisation documentation.

As at the closing date, in relation to each underlying exposure, no contractual agreement between the obligor and the original lender has been subject to any variation, amendment, modification, waiver or exclusion of time of any kind that in any material way adversely affects the enforceability or collectability of the underlying exposure.

Rationale for the criterion:

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

| | |
|--------------------|--|
| Criterion 3 | Eligibility criteria, no active portfolio management |
|--------------------|--|

| | |
|--|---------------|
| | Article 20(7) |
|--|---------------|

| | |
|---|---|
| Comparison with the criterion for traditional securitisation | Adaptation of the criterion: adaptation of allowed portfolio management techniques, inclusion of additional conditions for the removal of the underlying exposures in securitisation |
|---|---|

Content of the criterion

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

After the closing date, the securitisation should not be characterised by **an active portfolio management** on a discretionary basis. The following should, in principle, not be considered an active portfolio management:

- substitution of exposures that are in breach of representations and warranties;
- if the securitisation includes a replenishment period and the addition of exposures that meet clearly defined replenishment conditions.

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

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

- has been repaid or otherwise matured;
 - has been disposed of during the ordinary course of the protection buyer business, provided such a removal would not constitute implicit support for the purposes of Article 250 of the CRR;
 - is subject to a refinancing, restructuring or similar amendment that is not credit driven and that occurs during the ordinary course of servicing such an exposure (for example, maturity extension);
 - did not meet the eligibility criteria at the time it was included in the securitisation because of an error in the underlying exposures.
-

Rationale for the criterion

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

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

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

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

| | |
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| Criterion 4 | Homogeneity, enforceable obligations, full recourse to obligor, periodic payment streams |
| Comparison with the criterion for traditional securitisation | Article 20(8) Similar |

Content of the criterion

The underlying exposures should meet the following criteria:

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

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

Rationale for the criterion

See the overarching rationale for consistency with the traditional qualifying framework.

Commitment fees have been included, as some synthetic securitisations include unused credit lines or undisbursed loans as underlying exposure.

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

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| Criterion 5 | No transferable securities |
|--------------------|----------------------------|

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| Comparison with the criterion for traditional securitisation | Article 20(8) Similar |
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Content of the criterion

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

Rationale for the criterion

See the overarching rationale for consistency with the traditional qualifying framework.

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

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| Criterion 6 | No resecuritisation |
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| Comparison with the criterion for traditional securitisation | Article 20(9) Similar |
|---|---------------------------------|

Content of the criterion

The underlying exposures should not include any securitisation position.

Rationale for the criterion

See the overarching rationale for consistency with the traditional qualifying framework.

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

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

Content of the criterion

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

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

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

Rationale for the criterion

See the overarching rationale for consistency with the traditional qualifying framework.

Some arbitrage synthetic securitisations have been structured in the past with SSPEs as underlying obligors or by involving third parties, such as broker intermediaries, in the credit or underwriting decisions with respect to the underlying exposures. To ensure that only genuine balance-sheet securitisations of underlying exposures that are part of the core/business activity

of the originator can be eligible under the STS framework, no SSPEs should be allowed as obligors, and no broker intermediaries and similar parties should be involved in underwriting decisions.

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

Content of the criterion

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

Rationale for the criterion

See the overarching rationale for consistency with the traditional qualifying framework.

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| Criterion 9 | Borrower's creditworthiness |
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| Comparison with the criterion for traditional securitisation | Article 20(10) Similar |
|---|----------------------------------|

Content of the criterion:

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

Rationale for the criterion:

See the overarching rationale for consistency with the traditional qualifying framework.

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|---------------------|------------------------|
| Criterion 10 | Originator's expertise |
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| Comparison with the criterion for traditional securitisation | Article 20(10) Similar |
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Content of the criterion

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

Rationale for the criterion

See also the overarching rationale for consistency with the traditional qualifying framework.

In light of the criterion that requires that the underlying exposures should refer to a core lending/business activity of the originator/purchaser of the credit protection, this criterion appears less relevant in the case of synthetic securitisations than in the case of traditional securitisations. It has, however, still been kept, as, owing to strategic decisions, institutions may define new core/business activity in respect of which the required expertise has yet to be developed.

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

Content of the criterion

At the time of selection, the underlying exposures should not include:

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

Rationale for the criterion

See the overarching rationale for consistency with the traditional qualifying framework.

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

The debtors should, at the time of inclusion of the relevant exposures in the securitisation, have made at least one payment. This does not include revolving securitisations, in which exposures

are payable in a single instalment or have a maturity of less than one year, including without the limitation of monthly payments on revolving credits. This criterion does not apply to an exposure that represents the refinancing of a pre-existing exposure already included in the securitisation.

Rationale for the criterion

See the overarching rationale for consistency with the traditional qualifying framework.

STS synthetic securitisation should minimise the extent to which investors are required to analyse and assess fraud and operational risk. At least one payment should therefore be made by each underlying borrower at the time of inclusion of the exposure in the securitisation, since this reduces the likelihood of the exposure being subject to fraud or operational issues; this does not include revolving securitisations, in which the distribution of underlying exposures is subject to constant changes because the securitisation relates to exposures payable in single instalment or with an initial legal maturity of less than one year.

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

3.4.3 Standardisation criteria

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| Criterion 13 | Risk retention requirements |
| Comparison with the criterion for traditional securitisation | Article 21(1) Similar |

Content of the criterion

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

Rationale for the criterion

See the overarching rationale for consistency with the framework for traditional securitisation.

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

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| Criterion 14 | Appropriate mitigation of interest rate and currency risks |
| Comparison with the criterion for traditional securitisation | Article 21(2) |

Adapted to further specify measures for appropriate mitigation of interest rate and currency risks

Content of the criterion

Currency risk: The transaction documentation should clearly describe how any currency risk arising in synthetic securitisation will affect payments to the protection buyer and the investors.

- If applicable, any collateral securing the credit protection obligation must be denominated in the same currency as that used for the credit protection (i.e. the transaction currency).

Interest rate risk: The transaction documentation should clearly describe how any interest rate risk associated with synthetic securitisation will be mitigated and what impact it will have on the payments to the protection buyer and the investor.

In the case of a synthetic securitisation involving an SSPE, the amount of the SSPE's liabilities in terms of interest payments to investors at any payment date should be equal to or less than the amount of its income from the protection buyer and any collateral arrangements at such payment date.

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

Those derivatives should be underwritten and documented in accordance with common standards in international finance.

Rationale for the criterion

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

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

Currency risk: In synthetic securitisation transactions in which the underlying exposures are denominated in a currency that is different to the currency used for the credit protection (i.e. the transaction currency), there arises the risk that, because of exchange rate fluctuations and depending on the reference exchange rate used to convert loss amounts into protection payment amounts, the outstanding amount of the notes/available collateral/committed guarantee amount after conversion into the currency in which the underlying exposures are denominated may be reduced, resulting in diminished protection in respect of the underlying exposures. Even though the CRR provides for additional capital requirements on the originator for transactions

characterised by currency mismatches, it is important that the currency risk to which STS securitisation positions are exposed is appropriately mitigated. This can be done by ensuring that the credit protection is denominated in the same currency as the underlying exposures and, if relevant, collateral, or through other measures, such as using hedges and guarantees that can fix the currency rate for the protection buyer, or by other arrangements such as for example adapting the notional amount of the portfolio to manage exchange rate fluctuations through replenishment.

Interest rate risk: Interest rate risk should be appropriately mitigated. Additional criterion 35 provides for eligible credit risk protection arrangements. The exclusion of more complex collateral and re-investment arrangements in synthetic STS securitisations further reduces the extent to which interest rate mismatches may occur in such securitisations.

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

The appropriate mitigation of interest rate and currency risks should be clearly specified in the transaction documentation.

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| Criterion 15 | Referenced interest payments |
| Comparison with the criterion for traditional securitisation | Art 21(3) Similar |

Content of the criterion

Any referenced interest payments in relation to securitisation should be based on either (i) generally used market interest rates or generally used sectoral rates that are reflective of the cost of funds and do not reference complex formulae or derivatives, and/or (ii) income generated by the collateral securing the protection seller's obligations under the credit protection agreement.

Any referenced interest payments in relation to the underlying exposure should be based on either (i) generally used market interest rates, or generally used sectoral rates reflective of the cost of funds, and should not reference complex formulae or derivatives

Rationale for the criterion

This criterion is less relevant for synthetics, as the repayment of the securitisation positions is not dependent on the cash flows from the underlying exposures on a pass-through basis, and consequently there is less need for investors to understand the calculation of the interest payments on the underlying exposures. However, this information might still be useful,

particularly with regard to public synthetic securitisations making use of an SSPE with various investors, and the requirement should therefore be kept for consistency purposes.

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| Criterion 16 | Requirements after enforcement notice |
| Comparison with the criterion for traditional securitisation | Article 21(4) Adapted to reflect the fact that not all synthetic securitisations use SSPE |

Content of the criterion

Following the occurrence of an enforcement event in respect of the protection buyer, the protection seller should be permitted to take enforcement action and/or terminate the credit protection agreement. In the case of funded credit protection, upon such termination, collateral should be returned to investors in order of their seniority.

When an SSPE is used within a synthetic securitisation, following an enforcement or termination of the credit protection agreement, no amount of cash should be trapped in the SSPE beyond that which is necessary to ensure the operational functioning of the SSPE, the payment of protection payments in respect of defaulted underlying exposures that are still being worked out at the time of such a termination or the orderly repayment of investors, in accordance with the contractual terms of the securitisation.

Rationale for the criterion

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

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

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| Criterion 17 | Allocation of losses and amortisation of tranches |
| Comparison with the criterion for traditional securitisation | Article 21(5) Adapted with additional requirements for pro rata amortisation and allocation of losses requirements |

Content of the criterion

Allocation of losses: The allocation of losses to holders of a securitisation position in a synthetic

STS securitisation should always proceed in order of seniority of tranches, from the most junior tranche to the most senior tranche in the transaction.

Amortisation of size of tranches: Pro rata or hybrid (i.e. comprising a combination of pro rata and sequential, or pro rata applying to only some tranches) amortisation may only be applied to determine the outstanding amount of all tranches if clearly specified triggers relating to the performance of the underlying exposures ensure the switch of the amortisation scheme to sequential amortisation. Such performance-related triggers should at least include deterioration in the credit quality of the underlying exposures below a predetermined threshold.

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

As tranches amortise, when investors have provided collateral for those tranches, an amount of that collateral equal to the amount of amortisation on such tranches should be returned to investors. In the case of underlying exposures in relation to which a credit event has occurred and the workout process has not been completed, the amortisation provisions should ensure that the remaining amount of credit protection at any payment date is at least equivalent to the notional outstanding amount of these underlying exposures after consideration of the amount of any interim payments that have already been effected on these underlying exposures in relation to the relevant credit events.

All amortisation agreements should be clearly documented.

Rationale for the criterion

See the overarching rationale for consistency with the traditional qualifying framework.

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

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

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| Criterion 18 | Early amortisation provisions/triggers for termination of the revolving period |
| Comparison with the criterion for traditional securitisation | Article 21(6) Adapted with requirements for early amortisation only in the case of the use of an SSPE |

Content of the criterion

The transaction documentation should include appropriate triggers for the termination of the revolving period in which the securitisation is a revolving securitisation and a switch to the amortisation of tranches, including at least the following:

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

Rationale for the criterion

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

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

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

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| Criterion 19 | Transaction documentation |
| Comparison with the criterion for traditional securitisation | Article 21(7) Adapted with additional requirements for servicing standards and procedures |

Content of the criterion

The transaction documentation should clearly specify:

- the contractual obligations, duties and responsibilities of, as applicable, the verification agent, the servicer of the underlying exposures, the trustee and other ancillary service providers;

- upon default, insolvency and other specified events, where applicable, provisions to ensure the replacement of relevant counterparties (other than the protection buyer and the investors) for in cases where the respective services for the benefit of the securitisation are not provided by the originator itself;
- the processes and responsibilities necessary to ensure that, when servicing is not provided by the originator itself, the default or insolvency of the current servicer does not result in termination of servicing, such as contractual provisions that enable the replacement of the servicer in such cases;
- the servicing procedures that apply to the underlying exposures at the closing date and thereafter and the circumstances under which these procedures may be modified;
- the servicing standards that the servicer will have to adhere to in servicing the underlying exposures within the entire maturity of the synthetic securitisation.

Rationale for the criterion

See the overarching rationale for consistency with the traditional qualifying framework.

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

From the perspective of an investor in synthetic securitisation, it is also important that, irrespective of whether the underlying exposures are serviced by the originator or by another party, at closing date and thereafter, the servicer adheres to high servicing standards, in order to ensure that credit events covered by the credit protection agreement and corresponding losses are determined correctly at each payment date.

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| Criterion 20 | Servicer's expertise |
| Comparison with the criterion for traditional securitisation | Article 21(8) Similar |

Content of the criterion

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

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

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

securitised.

Rationale for the criterion

See the overarching rationale for consistency with the traditional qualifying framework.

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

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

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

Content of the criterion

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

Rationale for the criterion

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

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| Criterion 22 | Timely resolution of conflicts between investors |
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| Comparison with the criterion for traditional securitisation | Article 21(10) Similar |
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Content of the criterion

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

Rationale for the criterion

See the overarching rationale for consistency with the traditional qualifying framework.

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

3.4.4 Transparency criteria

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| Criterion 23 | Data on historical default and loss performance |
| Comparison with the criterion for traditional securitisation | Article 22(1) Similar |

Content of the criterion

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

Rationale for the criterion

See the overarching rationale for consistency with the traditional qualifying framework.

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

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| Criterion 24 | External verification of the sample |
| Comparison with the criterion for traditional securitisation | Article 22(2) Similar |

Content of the criterion

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

Rationale for the criterion

In synthetic securitisation, compliance with contractual eligibility criteria determines the validity and therefore the effectiveness of the credit protection. From a transparency perspective, it is crucial to ensure that any potential for disputes over the validity of the credit protection is minimised during the life of the transaction. For this reason, in the case of synthetic securitisation, the audit prior to issuance should specifically cover eligibility conditions and should be carried out with a confidence level of at least 95%.

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| Criterion 25 | Liability cash flow model |
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| Comparison with the criterion for traditional securitisation | Article 22(3) Similar |
|---|---------------------------------|

Content of the criterion

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

Rationale for the criterion

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

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| Criterion 26 | Environmental performance of assets |
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| Comparison with the criterion for traditional securitisation | Article 22(4) Similar |
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Content of the criterion

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

Rationale for the criterion

See the overarching rationale for consistency with the traditional qualifying framework.

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| Criterion 27 | Compliance with transparency requirements |
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| Comparison with the criterion for traditional securitisation | Article 22(5) Similar |
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Content of the criterion

The originator should be responsible for compliance with Article 7 of the Securitisation Regulation. The information required by point (a) of the first subparagraph of Article 7(1) should be made available to potential investors, upon request, before pricing. The information required by points (b) to (d) of the first subparagraph of Article 7(1) should be made available before pricing at least in draft or initial form. The final documentation should be made available to investors at the latest 15 days after the closing of the transaction.

Rationale for the criterion:

See the overarching rationale for consistency with the traditional qualifying framework.

3.4.5 Criteria specific to synthetic securitisation

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| Criterion 28 | Credit events |
| Comparison with the criterion for traditional securitisation | N/A |

Content of the criterion

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

- failure to pay the underlying obligor, defined to encompass at a minimum the circumstances defined in Article 178 (1)(b) of the CRR;
- bankruptcy of the underlying obligor, defined to encompass at a minimum the circumstances defined in Article 178 (3)(e) and (f) of the CRR;
- in the case of credit protection other than financial guarantee, restructuring of the underlying exposure, defined to encompass at a minimum the circumstances defined in Article 178(3) (d) of the CRR.

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

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

Rationale for the criterion

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

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

Forbearance measures, which consist of concessions towards a debtor that is experiencing or

about to experience difficulties in meeting its financial commitments, should not preclude the triggering of the credit protection event. In this regard, the term ‘concessions’ refers to either a modification of the previous terms and conditions of a contract that the debtor is considered unable to comply with because of its financial difficulties (‘troubled debt’), resulting in insufficient debt service ability, and that would not have been granted had the debtor not been experiencing financial difficulties, or a total or partial refinancing of a troubled debt contract that would not have been granted had the debtor not been experiencing financial difficulties. A concession may entail a loss for the lender, which should be considered within the credit protection agreement.

Restructuring has been excluded as a credit event in the case of financial guarantees, in order to avoid them being treated as a derivative in accordance with the relevant accounting standards. The underlying reference portfolio is often held in the banking book and is therefore subject to accrual accounting, while derivatives are subject to mark-to-market. Financial guarantees, however, are typically accrual accounted; nevertheless, if a financial guarantee also references restructuring, then it may have to be treated as a derivative in accordance with the relevant accounting standards. Therefore, buying protection for portfolios held on the banking book in the form of a financial guarantee rather than a derivative avoids mark-to-market volatility.

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| Criterion 29 | Credit protection payments |
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| Comparison with the criterion for traditional securitisation | N/A |
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Content of the criterion

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

The final credit protection payment should be payable within a specified period following the end of the workout process for the relevant underlying exposure if the end of the workout process occurs before the scheduled legal maturity or early termination of the credit protection agreement.

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

The interim credit protection payment should be, at least, the higher of the impairment considered by the originator in its financial statements, in accordance with the applicable accounting framework, at the time the interim payment is made or, if applicable, the LGD

¹⁴ The term ‘exposure type’ is used here, to avoid confusion with the term ‘type of exposure’, as defined for IRB purposes according to Art. 142(1)(2) of the CRR.

determined in accordance with Part Three, Title II, Chapter 3, of the CRR, which, according to the CRR, has to be applied to the corresponding underlying exposures in order to determine the IRB capital requirements on the originator for such underlying exposures. If an interim credit protection payment is made, a final credit protection payment should be made in order to adjust the interim settlement of losses to the actual realised loss, in accordance with the first paragraph of this criterion.

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

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

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

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

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

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

Rationale for the criterion

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

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

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

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

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| Criterion 30 | Credit protection payments following the close out/final settlement at the final legal maturity of the credit protection agreement |
| Comparison with the criterion for traditional securitisation | N/A |

Content of the criterion

With regard to underlying exposures for which a credit event has occurred and the workout process has not been completed upon the scheduled legal maturity or early termination of the credit protection agreement, the credit protection agreement should clearly specify the maximum extension period that should apply to the workout process for those exposures. Such an extension period should not be longer than two years.

A final credit protection payment within this extension period should be made on the basis of the final estimated loss expected to be suffered by the originator and recorded by the originator in its financial statements at that time.

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

Rationale for the criterion

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

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| Criterion 31 | Credit protection premiums |
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Comparison with the criterion for traditional securitisation

N/A

Comparison with other sources
Content of the criterion

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

The transaction documentation should clearly describe how the protection fee and any note coupons are calculated in respect of each payment date over the life of the securitisation.

The rights of the protection seller to receive credit protection premiums under synthetic securitisation should be enforceable.

Rationale for the criterion

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

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

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

Criterion 32

Verification agent

Comparison with the criterion for traditional securitisation

N/A

Content of the criterion

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

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

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

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

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

Rationale for the criterion

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

| Criterion 33 | Early termination events |
|--|--------------------------|
| Comparison with the criterion for traditional securitisation | N/A |

Content of the criterion

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

- Relevant regulatory events, which should:
 - include relevant changes in any law and/or regulation (or official interpretation of that law and/or regulation by competent authorities) or the tax or accounting treatment of a transaction that have a material adverse effect on the amount of capital that the protection buyer is required to hold in connection with the securitisation or the underlying exposures, in each case compared with that anticipated at the time of entering into the transaction, which was reasonable unforeseeable at that time.
 - include a determination by a competent authority that the protection buyer (or any affiliate of the protection buyer) is not or is no longer permitted to recognise significant risk transfer in respect of the securitisation, in accordance with Article 245 of the CRR;
 - exclude other factors affecting the economic efficiency of the transaction that are not enshrined in law or regulation, such as credit rating agencies' methodologies and a central bank's collateral framework.
- A time call is exercised, at a point in time when the time period measured from the securitisation's closing date is equal to or higher than the weighted average life of the initial reference portfolio at closing. The time call should not be structured to avoid allocating losses to credit enhancement positions or other positions held by investors and should not be otherwise structured to provide credit enhancement.
- A call as per Article 245(4)(f) of the amended CRR is exercised (clean-up call).

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

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

Rationale for the criterion

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

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

seen from two perspectives:

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

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

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

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| Criterion 34 | Synthetic excess spread |
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| Comparison with the criterion for traditional securitisation | N/A |
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Content of the criterion

The originator (protection buyer) can commit to the SES, which is available as credit enhancement for the investors under the following conditions:

- The amount of the SES that the originator commits to using as credit enhancement at each payment period is predetermined in the contract and expressed as a fixed percentage of the total outstanding portfolio balance (fixed SES).
-

- The SES may be used to cover credit losses that materialise during each payment period. The SES that is not used for that purpose during the payment period is returned to the originator (use-it-or-lose-it mechanism).
- The total committed amount every year may never be higher than the one-year regulatory expected loss on the underlying portfolio (in order to ensure that originators do not commit amounts of excess spread that are excessive/can hardly be generated by the portfolio).

If any SES is included in a transaction, these conditions should be clearly specified in the transaction documentation.

Rationale for the criterion

The SES is widely present in synthetic securitisation transactions, it is a helpful mechanism for both investors and originators, and it is also available in traditional STS securitisation transactions.

Furthermore, the SES is essential for some specific retail asset classes (e.g. SME and consumer lending) that benefit from the higher yield for investors and for which the underlying exposures generate higher losses and excess spread to cover for those losses. Not allowing the inclusion of SES among the STS criteria would substantially limit the use of STS balance-sheet synthetics for many asset classes.

However, if the amount of SES subordinated to the investor (protection seller) position is too high, it is possible that under no realistic scenario will the investor (protection seller) in the securitisation positions be eroded by losses, resulting in no effective risk transfer.

This could be the result of an inappropriate specification of SES amounts within transactions that use actual excess spread, or could occur in transactions that contractually commit a predetermined amount of excess spread that is not proportionate to the level of risk that characterises the portfolio, e.g. as measured by the portfolio's expected and unexpected loss amount, or cannot be generated by the portfolio (e.g. in the case of yield-impaired portfolios).

The use of SES in balance-sheet synthetics can pose material concerns in relation to SRT; given this, it is important to specify strict criteria, to mitigate supervisory concerns and further standardise this structural feature, and to ensure full disclosure on the use of excess spread.

For the avoidance of doubt, the SES criterion for balance-sheet synthetics does not impede or prevent any consideration of competent authorities when assessing if SRT and commensurate risk transfer has been achieved by an originator. The final EBA report on SRT, which is expected to be published before January 2021, will provide considerations on SES for the purpose of SRT and commensurate risk transfer.

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| Criterion 35 | Eligible credit protection agreement, counterparties and collateral |
| Comparison with the criterion for traditional securitisation | N/A |

Content of the criterion

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

- A. a guarantee meeting the requirements set out in Chapter 4 of Part Three, Title II, of the CRR, by which the credit risk is transferred to any of the entities listed under Article 214 (2)(a)-(d) of the CRR, provided that the exposures to the protection provider qualify for a 0% risk weight under Chapter 2 of Part Three, Title II, of the CRR;
- B. a guarantee meeting the requirements set out in Chapter 4 of Part Three, Title II, of the CRR, which benefits from a counter-guarantee of any of the entities referred to in point (A);
- C. other credit protection in the form of guarantees, credit derivatives or credit link notes not referred to under the previous two points, that is meeting the requirements set out in Sub-Section 2 of Section 3, Chapter 4, of Part Three, Title II, of the CRR, as amended by Article 249 of the CRR, provided that the obligations of the protection seller are subject to the following collateral requirements.

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

- Collateral in the form of 0% risk-weighted debt securities that have a short remaining maturity of maximum three months, matching the payment dates, which are redeemed into cash in an amount equal to the outstanding balance of the protected tranche and which are held by a custodian independent of the protection buyer and the protection seller.
- Collateral in the form of cash held with a third-party credit institution or in the form of cash on deposit with the protection buyer, subject to a minimum credit quality standing requirement, meaning that, if the third-party credit institution or the protection buyer ceases to satisfy that minimum credit quality standing, it is required either to transfer the collateral to a third-party bank that does have the minimum credit quality standing or to invest the cash collateral in high-quality securities held by a custodian or the protection buyer. The requirements set out in this paragraph would be deemed to be satisfied in the case of the investments of the collateral coming from credit linked notes issued by the originator, in accordance with Article 218 of the CRR.

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

- The right of the protection buyer to use the collateral to meet protection payment obligations of the protection seller should be enforceable. Security arrangements should be provided to ensure this right of the protection buyer.

- The right of the investors, when the synthetic securitisation is unwound or as the tranches amortise, to return any collateral that has not been used to meet protection payments should be enforceable.
- if collateral is invested in securities, the securitisation documentation should set out the eligibility criteria and custody arrangement for such securities.

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

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

Rationale for the criterion

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

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

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

If the counterparty is not recognised by the CRR as being eligible for a 0% risk weight, the resulting counterparty credit risk can be mitigated by requiring the counterparty to fund the credit protection by providing high-quality collateral (which in the case of synthetic securitisation may include the issuance of credit linked notes when making use of an SSPE). In order to mitigate the counterparty credit risk for both the originator and the protection seller, such high-quality collateral in the form of 0% risk-weighted debt securities should be held with a third party (such as EU government securities or securities of supranational entities held in a trust or a similar entity), and, when it is in the form of cash, it should be held either with a third-party credit institution or on deposit with the protection buyer, subject in both cases to a minimum credit quality standing.

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

3.5 Framework for a differentiated regulatory treatment of STS synthetic securitisation

3.5.1 The rationale underlying the approach to regulatory treatment

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

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

111. On the other hand, one of the main deficiencies is that the preferential regulatory treatment is not envisaged in the Basel standards, and there is very limited experience with the STS traditional framework so far. In addition, limitations of the performance data on which the analysis in this report is based should be taken into account. Furthermore, the introduction of a differentiated capital treatment for STS synthetic securitisations could potentially lead to an overuse of synthetic securitisation and provide an incentive for banks to implement a potential large-scale substitution of regulatory capital through risk mitigation strategies (i.e. RWA reductions), which could result in banks' increased leverage if not properly monitored and supervised.

Technical feasibility of the creation of the STS synthetic securitisation product

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

Solid rationale for the STS synthetic securitisation product

113. There appears to be a good rationale for the development of the STS synthetic securitisation product. There seem to be no convincing strong arguments against the development of the STS product. There are no material negative consequences, but there are a number of positive

benefits for banks, the financial market and financial stability in general from the introduction of such a product.

Market characteristics, trends and developments

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

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

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

Good performance of the synthetic securitisation

115. The available performance data do not evidence worse performance of the synthetic securitisation instrument than of the traditional securitisation instrument. The available data confirm that the balance-sheet synthetic transactions perform better than arbitrage deals, tend to outperform traditional securitisation and perform broadly consistently with comparable underlying exposures. From a consistency perspective, if the differentiated risk-weight treatment is already assigned to certain synthetic securitisations of SME exposures under Article 270 of the amended CRR, its extension to other asset classes could be considered.

116. The available data confirm the following:

- a. The arbitrage synthetics have performed materially worse than the balance-sheet transactions.
- b. The balance-sheet synthetics have performed better than traditional securitisations, for all asset classes (SME CLOs, RMBS, CMBS and other CLOs).
- c. The same applies for all the rating grades. The default performance of balance-sheet synthetics is better than that of the traditional securitisation, for all selected asset classes (all as of the end of 2018).
- d. In terms of rating transition (i.e. using the average number of notches of rating transition over the life of the tranche as a measure of average credit quality change incurred by the tranche), balance-sheet synthetic tranches perform better than true sale tranches, with the exception of the asset class of 'other CLOs'.
- e. Default and loss rates on senior tranches are zero in the case of a significant majority of reported transactions and asset classes. An exception are SMEs, for which the average annual default rate on 21 reported transactions is 0.11% and the annual loss rate is 0.02%.
- f. The default and loss rates are slightly higher when considering the whole portfolio (i.e. all tranches and not senior tranches only), but they are still very low (with respect to annual default rates, the value is in every case below 1%). The default and loss rates are highest for SMEs, followed by specialised lending. The average annual default rate for SMEs is 0.59%, while the maximum reported amount is 1.77%.
- g. Both the default rate and the loss rate are lower than those of comparable portfolios (comparable portfolios are defined in the sample as portfolios from the same business division or using the

same rating model as the securitised pool). This indicates that the originators systematically choose core exposures for the synthetic securitisation, with better default and loss performance than comparable exposures held on the balance sheet, and do not ‘cherry pick’ exposures with bad performance.

Regulatory alignment and consistency with the STS traditional framework

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

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

118. Article 270 of the Securitisation Regulation already assigns preferential capital treatment to some synthetic securitisations (senior tranches of SME securitisations held by originators). In addition, the practicability of the provisions on STS treatment of synthetic securitisation of SME portfolios in Article 270 of the CRR has proved to be limited. These provisions have been specifically designed based on the criteria defined for traditional securitisation, and are difficult to apply to synthetic products without further interpretation or clarification of the STS traditional criteria in a similar manner, as introduced in this report.

Impact of the (STS) synthetic securitisation on the financial markets and stability

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

Deviations from the Basel standards

120. On the one hand, it should be noted that one of the main deficiencies of the STS framework for synthetics is that it is not included in the Basel standards. The existing Basel STC framework covers only traditional securitisation and is not extended to synthetic securitisation. It is also unlikely that this framework — in particular the more risk-sensitive regulatory treatment — will be developed in the future, taking into account the fact that no consensus has been reached between Basel members. On the other hand, deviations from the Basel standards are not

without precedence (for example, the EU extends more favourable treatment to covered bonds than the Basel standards).

Data limitations

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

Other considerations

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

123. In addition, on-balance-sheet synthetic securitisation will free up regulatory capital if SRT is acknowledged by a bank and not objected to by the competent authority. This capital relief will be higher in the event that a preferential capital treatment, which currently applies to traditional non-STC securitisations¹⁵, is introduced for synthetics. Essentially, the transfer of risk via synthetic securitisations implies an increase in leverage of the originating bank and might provide disincentives for banks to restructure their business model (e.g. via mergers, more use of digitalisation). The introduction of a differentiated capital treatment for STS synthetic securitisations could lead to a potential overuse of synthetic securitisation and provide an incentive for banks to implement a potential large-scale substitution of regulatory capital through risk mitigation strategies (i.e. RWA reductions), which could result in banks' increased leverage if not properly monitored and supervised. It is therefore important that banks use synthetics as a complementary tool in their capital management and risk management and implement a proper governance structure to ensure that synthetic securitisation is not overused.

¹⁵ For traditional securitisations that fulfil the STS criteria, the minimum capital requirement of senior tranches is 10%, which is 41% higher than that applied under the Basel II/CRR securitisation framework, which had a floor of 7%. The Basel Committee has mentioned 'insufficient capital for certain exposures' as one of the shortcomings of the Basel II securitisation framework and has therefore increased the capital requirements, including increasing the floor to 10% for STC and to 15% for non-STC securitisations.

3.5.2 Scope of regulatory differentiation

124. The evidence and the technical analysis carried out in this report suggest that an STS balance-sheet synthetic securitisation framework can be created, thereby increasing the alignment of interest between the originator and investor and the transparency of the product and underlying exposures. Taking into account recommendation 1 and recommendation 2, the agency risk and modelling risk of an STS balance-sheet synthetic securitisation will be reduced compared with non-STS balance-sheet synthetics. Therefore, this could justify, from a technical point of view, a differentiated regulatory treatment compared with non-STS balance sheet synthetic, in the event that the securitisation is backed by any of the asset classes under Article 243(2) of the amended CRR.

125. Such differentiated regulatory treatment could consist of an adjustment of the prudential floor for the senior tranche retained by the credit institutions to a level applicable under the STS traditional framework and corresponding adjustments of the risk weights for the senior tranche as applicable under the STS traditional framework (i.e. recalibration under formulae-based approaches to include a 50% haircut of the supervisory 'p' parameter and recalibration of the approach based on external ratings to achieve a lowering of risk weights that is consistent with the recalibration of the former approaches).

126. This limited differentiated regulatory treatment, rather than a fully fledged preferential regulatory framework, could represent a balanced approach that considers all the arguments analysed in the previous section and should also be subject to the following conditions and constraints:

- The securitisation meets all the requirements on simplicity, standardisation and transparency and criteria specific to synthetic securitisation, as specified in Section 5.4.
- The securitisation meets the criteria set by Article 243(2) of the amended CRR.
- The securitisation is a balance-sheet synthetic securitisation.
- The position is held (retained) by the originating credit institution.
- The position qualifies as the senior securitisation position.
- The differentiated regulatory treatment should not be extended beyond the capital treatment (i.e. to liquidity treatment, etc.).

127. However, the evidence and the technical analysis carried out in this report raised several concerns related to the introduction of a differentiated regulatory treatment of the STS synthetic securitisation at the current stage. These include the following:

- Although the data provide a positive picture of the synthetic market with zero default for the senior tranche, there are limitations with the data and transactions analysed concerning

the scope, representativeness and limited time horizon of the data, which do not cover the full economic cycle.

- There is limited experience with STS framework in general, as it entered into force in January 2019. Hence, from a prudential point of view, the introduction of a differentiated capital treatment for the STS framework for synthetic securitisation might not be fully justified at this stage.
- The Basel Committee stated in February 2016 that synthetic securitisations should not fall under the scope of the STC framework for regulatory capital purposes, and any potential adoption of this framework in future remains highly unlikely.
- The introduction of a differentiated capital treatment for STS synthetic securitisations could lead to a potential overuse of synthetic securitisation and provide an incentive for banks to implement a potential large-scale substitution of regulatory capital through risk mitigation strategies (i.e. RWA reductions), which could result in banks' increased leverage if not properly monitored and supervised.

128. Considering the above, the introduction of any potential legislative solution enabling differentiated regulatory treatment should be accompanied by a mandate to the EBA to monitor the functioning of the STS synthetic market, the use of such differentiated capital treatment and whether or not its application might exhibit the risk of excessive leveraging of banks' balance sheets and potential substitution of the issuance of capital instruments.

3.6 EBA recommendations

RECOMMENDATION 1:

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

RECOMMENDATION 2:

The EBA recommends that, for any synthetic securitisation to be eligible for the status of 'STS', it shall comply with the criteria on simplicity, standardisation and transparency, including the criteria specific to synthetic securitisation, as specified in Section 3.4.

RECOMMENDATION 3:

Taking into account recommendation 1 and recommendation 2, from a technical point of view, the agency risk and modelling risk of an STS balance-sheet synthetic securitisation will reduce, compared with non-STS balance-sheet synthetics. Therefore, the evidence and the technical analysis carried out in this report could justify a potentially differentiated regulatory treatment compared with the non-STS balance-sheet synthetic securitisation, in the event that the STS balance-sheet synthetic securitisation meets the criteria under Article 243(2) of the amended CRR.

The EBA recommends that, if introduced, such differentiated regulatory treatment should be limited and targeted in scope and should not be extended to a fully fledged cross-sectoral preferential regulatory treatment for synthetic securitisations (i.e. applicable to all tranches and both originating and investing institutions).

Such differentiated regulatory treatment should consist of an adjustment of the prudential floor for the senior tranche retained by the credit institutions to a level applicable under the STS traditional framework and corresponding adjustments of the risk weights for the senior tranche as applicable under the STS traditional framework (i.e. recalibration under formulae-based approaches to include a 50% haircut of the supervisory ' ρ ' parameter and recalibration of the approach based on external ratings to achieve a lowering of risk weights that is consistent with the recalibration of the former approaches).

The differentiated regulatory treatment should be subject to the following conditions:

- The securitisation meets the requirements on simplicity, standardisation and transparency and the criteria specific to synthetic securitisation, as specified in Section 3.4.
- The securitisation meets the criteria under Article 243(2) of the amended CRR.
- The securitisation is a balance-sheet synthetic securitisation.

- The position is held (retained) by the originating credit institution.
- The position qualifies as the senior securitisation position.

However, the evidence and the technical analysis carried out in this report raised several concerns related to the introduction of a differentiated regulatory treatment of the STS synthetic securitisation at the current stage. These include the following:

- Although the data provide a positive picture of the synthetic market with zero default for the senior tranche, there are limitations with the data and transactions analysed concerning the scope, representativeness and limited time horizon of the data, which do not cover the full economic cycle.
- The experience with the STS framework, which entered into force in January 2019, is limited. Hence, from a prudential point of view, the introduction of a differentiated capital treatment for the STS framework for synthetic securitisation might not be fully justified at this stage. The Basel Committee stated, in February 2016, that synthetic securitisations should not fall under the scope of the STC framework for regulatory capital purposes. The introduction of a differentiated capital treatment for STS synthetic securitisations could lead to a potential overuse of synthetic securitisation and provide an incentive for banks to implement a potential large-scale substitution of regulatory capital through risk mitigation strategies (i.e. RWA reductions), which could result in banks' increased leverage if not properly monitored and supervised.

The EBA recommends that the introduction of any potential legislative solution enabling differentiated regulatory treatment should be accompanied by a mandate to the EBA to monitor the functioning of the STS synthetic market, the use of such differentiated capital treatment and whether or not its application might exhibit the risk of excessive leveraging of banks' balance sheets and potential substitution of the issuance of capital instruments.

The Commission should take into account all the above mentioned considerations when deciding whether or not the introduction of a differentiated capital treatment for STS balance-sheet synthetic securitisation is justified at this stage.



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