Legitimate questions

The adoption of STS synthetic securitisation has helped legitimise the capital relief trades market. However, as **Stelios Papadopoulos** reports, the EBA's most recent consultations could prove challenging.

STS synthetic securitisation issuance has soared since the execution of the first transaction in June 2021, adding momentum to this year's capital relief trade deal flow, further legitimising the market and broadening the investor base. However, the EBA's recent consultations on synthetic excess spread and homogeneity criteria could pose challenges for the market going forward, if the proposals are implemented as they stand.

The impact of the coronavirus crisis on the European economy boosted efforts to establish an STS framework for synthetic securitisations. Indeed, based on an EBA report from May 2020 and swift action from regulators, the STS label for synthetic securitisations was introduced by the European Commission in April 2021 as part of the Capital Markets Recovery Package (CMRP).

The CMRP amended the Securitisation Regulation to include STS requirements for on-balance sheet securitisations, thereby extending the STS framework to synthetic securitisations *(SCI 26 March 2021)*. The main objective was to facilitate Europe's economic recovery and allow banks to maintain and enhance their capacity to lend to SMEs and the real economy.

According to ESMA data, the number of STS synthetic securitisations now total 40 in number, following the finalisation of the first STS synthetic securitisation in June 2021. The high transaction activity seen in the first year of STS synthetic ABS demonstrates that the framework ▶

Michael Osswald, STS Verification International

has added positive momentum to the development of the CRT market.

The figures are substantial when compared to overall market notional issuance. SCI data show that the number of deals for the first half of this year has now reached 34 overall, compared to 31 for the first half of last year. Last year proved to be a record, with nearly 70 transactions executed.

PGGM has been one of the most active investors in the STS SRT space. The firm has now closed €1.1bn across five such transactions, referencing underlying portfolios of €27.6bn with banks across Europe. Most of these trades were executed with Swedish pension fund Alecta.

As expected, the bulk of the STS SRT market consists of corporate and SME loan deals. "We started seeing STS deals in mid-2021 and the underlying pools have been dominated by large corporate and SME loans, but we've also seen residential and shipping loans," says Michael Osswald, md at STS Verification International.

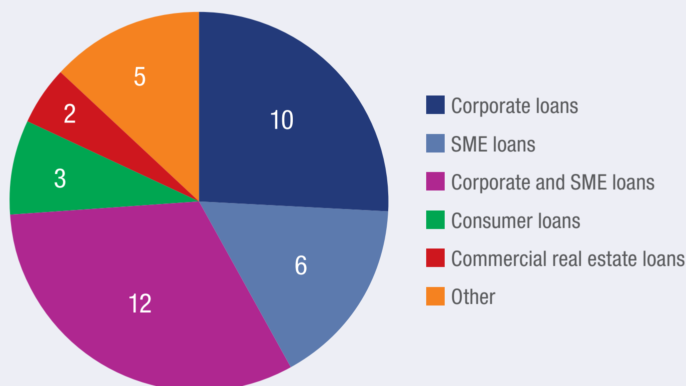
Single concentrations for the transactions must be less than 2% of the portfolio for the deal to be able to benefit from the favourable capital treatment of the STS regime. This could be a problem for less granular portfolios, but is in practice mitigated by banks syndicating the loan or limiting the size of the exposure that goes into a securitisation.

Moreover, the synthetic format works better for some portfolios compared to the cash format. Harry Noutsos, md at PCS, notes: "STS synthetics can be done on a wide range of assets, including CRE or shipping. The biggest challenge for cash deals backed by CRE or shipping loans is refinancing risk."

He continues: "If unguaranteed residual value risk is over 50% in a cash ABS, then you cannot achieve STS. These types of loans amortise partially and not down to zero, so they struggle to meet the 50% requirement of cash deals. Yet no such requirement exists for synthetics where investors take on the refinancing risk."

Deal structures are varied and include unfunded deals with EIF participation, funded structures using SPVs with collateral in the form of cash on deposits or 0% risk weighted debt securities and direct CLNs.

Figure 1: STS SRT portfolios 2021-2022



Source: ESMA

STS brings additional requirements for synthetic securitisations – most notably stipulations on termination events, stricter collateral requirements and additional transparency requirements. The STS requirements around termination events, in particular, raise real challenges for banks wishing to turn their legacy deals into STS-compliant ones.

Suzana Sava Montanari, partner at Latham & Watkins, comments: "One of the major issues with legacy SRTs is that certain termination rights can't be used by investors in STS deals. The only terminations available to them are failure to pay and material breaches by the originator. Termination rights are a particular challenge for SPV structures, since although banks can support the SPV, there are situations where if that doesn't pay over to the investors, then the investors can't terminate the deal."

> "THE BIGGEST CHALLENGE FOR CASH DEALS BACKED BY CRE OR SHIPPING LOANS IS REFINANCING RISK"

Harry Noutsos, PCS

Legacy trades can be amended into STS synthetic securitisations and the Securitisation Regulation allows this on a retroactive basis. Yet the problem with existing deals more generally is that some STS criteria must apply at the time of notification, while others apply at the time of original closing. Hence, amendments are achievable but cumbersome *(SCI 14 April)*.

Furthermore, determining whether loans acquired from other originators in secondary transactions were underwritten according to the same standards isn't straightforward. The latter is further complicated by the need to carry out an agreed-upon procedure (AUP) or audit, for which the same criteria as traditional cash ABS AUPs do not necessarily apply.

Nevertheless, the greatest challenge for STS SRTs right now are the latest proposals under the EBA's consultations regarding the homogeneity criteria and the determination of the exposure value of synthetic excess spread in STS synthetic securitisations.

As part of the CMRP, the EBA is mandated to develop draft regulatory technical standards (RTS) that further specify which underlying exposures are deemed to be homogeneous as part of the simplicity requirements *(SCI 5 August)*,

as well as clarify how banks will determine the exposure value of synthetic excess spread *(SCI 11 August)*. From the EBA's perspective, the aim of the consultation on the RTS for the homogeneity criteria of STS synthetic securitisations was to level the playing field with traditional ABS.

One of the main ways of doing so was to draw a line around the definition of large corporate exposures. This aims to ensure sufficient obligors in the portfolio and an easier analysis of the underlying pool.

In particular, the proposals adjust the homogeneity factors for on-balance sheet securitisations and more specifically the 'type of obligor' related to corporate and SME exposures. The latter exposures comprise the bulk of the synthetic ABS market. According to the consultation, banks treat large corporate exposures differently from the rest of their corporate book, which in turn are subject to similar credit granting criteria as SMEs.

Consequently, to ensure a consistent and harmonised application of the requirements – considering that the term 'large corporate' varies greatly across jurisdictions – it was decided that the 'large corporate' definition would be used from the Commission's CRR 3 proposals. The CRR 3 proposals define the term as "any corporate undertaking having consolidated annual sales of more than €500m or belonging to a group where the total annual sales for the consolidated group is more than €500m."

The EBA wanted to use the same concepts from Basel 3, which explains the choice of the definition of large corporate exposures. Eirini Kanoni, policy expert at the EBA, notes: "The treatment of large corporate loans changes under Basel 3, since the modelling of LGDs under the IRB approach will no longer be possible for large corporates. Overall, risk drivers are therefore expected to be treated differently on bank balance sheets, so we had to align those balance sheets with the new securitisation rules. This explains our choice of the definition of large corporate exposures, which we are now consulting on."

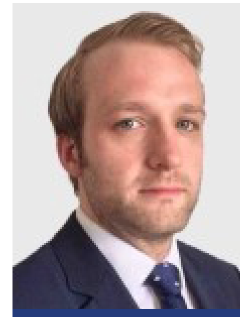
Pablo Sinausia, EBA

However, CRT structurers argue that Basel 3 isn't yet in force, while pointing out that the EBA has missed the deadline in making these changes. Nevertheless, the larger issue is the inability to mix corporate and SME loans, with no clear rationale and with the risk of ending up with less granular portfolios and less financing to SMEs.

Regarding the consultation on synthetic excess spread, the EBA provides two approaches – called the full model and simplified approach respectively – although both are effectively the same, since the focus remains on lifetime expected losses. Pablo Sinausia, policy expert at the EBA, explains: "The simplified model approach stipulates that if a deal has a 10-year legal final maturity, you can calculate it to the time call rather than the maturity. It also includes a scaler that reduces the exposure value of 'use it or lose it' (UIOLI) synthetic excess spread mechanisms."

He continues: "In the full model approach, on the other hand, the lower loss absorbing capacity of UIOLI synthetic excess spread compared to a trapped mechanism is already considered in the modelling."

The ECB's approach is very different and is based on the amount of committed excess spread in excess of expected losses – mimicking the approach currently used for true sale securitisations, which originators are unequivocally in favour of.


David Saunders, Santander

David Saunders, executive director at Santander, comments: "The EBA's paper is so prescriptive regarding the calculation of synthetic excess spread that when you consider it with all the other regulations, it raises real modelling complexity. The main driver of complexity in synthetic securitisations in the EU now is regulation by some distance."

> "THE MAIN DRIVER OF COMPLEXITY IN SYNTHETIC SECURITISATIONS IN THE EU NOW IS REGULATION BY SOME DISTANCE"

The EBA has responded to lender concerns by stating that the revisions to the CRR prescribe a focus on lifetime expected losses when it comes to the capital calculation approach of synthetic excess spread. However, lenders have noted that the CRR can be interpreted in "different ways". ■

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