

Why synthetic securitisations are important for the European Capital Markets Union

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1. Securitisation in the context of Capital Markets Union

Both the "High Quality Securitisation" (HQS) and "Capital Markets Union" European projects are on the one hand closely interrelated, on the other hand significantly influential for the future framework and relevance of securitisation in Europe. Even though hard and intense work on both projects has been going on for quite some time and comprehensive, far-reaching concepts have been developed, the synthetic securitisation instrument type of securitisation has been added rather late to the agenda. As a result, and taking into account the latest regulatory advice provided by the EBA to COM in its report dated July 2015, synthetic securitisation will not qualify as HQS³. Nevertheless, both the EBA and COM are currently conducting analyses and conceptual considerations which, in the short or medium term, might lead to an extended catalogue of eligible securitisation types, beyond True Sale and ABCP.

In all likelihood, securitisation will play an important role in the context of the European Capital Markets Union and will effectively help to revitalize the securitisation market, provided that the HQS project is successfully implemented at short notice. Against this background, the COM Green Paper regarding the Capital Markets Union as of February 2015 stipulates⁴: "*Securitisation (...) can provide a powerful mechanism for transferring risk and increase capacity for banks to lend (...) A sustainable high quality securitisation market (...) could bridge banks and capital markets.*"⁵. This complementary approach has to be appreciated. Taking into account the size class breakdown of European enterprises, it appears to be imperative and "without any alternative". Considering their size,⁶ concomitant related financial transaction / issuance volumes and their organizational set up, the lion's share of European SMEs and, by the same token, most European enterprises will not be able and will not be seeking to tap the capital market directly. Against this backdrop, the Capital Markets Union should primarily serve to support and stimulate bank lending to SMEs via the capital market and via securitisation, and should not strive to substitute bank financing by capital markets financing whatever it takes.

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³ Cf. EBA „Report on qualifying securitisations. Response to the Commission's call for advice of January 2014 on long-term financing": *"The framework proposed in this report does not cover synthetic securitisation transactions as the EBA acknowledges that defining a synthetic securitisation-specific qualifying framework requires further analysis and market assessment, given the different nature of synthetic transactions and the variety of market practices that currently exist in this segment."*

⁴ Cf. COM „Green Paper – Building a Capital Markets Union“, 18 February 2014.

⁵ Against this background in its Green Paper, COM identifies the European work around HQS as one short term top priority regarding the Capital Markets Union. In this context and in parallel, COM also carried out a consultation on HQS in February 2015. While the messages in the Green Paper all in all are still kept in a more general style, COM is expected to publish a detailed action plan to achieve the Capital Markets Union as well as a comprehensive HQS draft regulation by end of September 2015 – hence after submission of this article to the publishers.

⁶ More than 99% of all enterprises in the European Union fall under the SME definition of KOM (maximum 250 employees and maximum 50 million euros turnover or 43 million euros balance).

2. Risk Transfer and Capital Relief determine the scope for lending

Even though the fundamental approach adopted by COM and the EBA is very welcome, it has to be said that it falls short of what would have been possible, to say the least, since its focus is limited exclusively to True Sale securitisations. This limitation might be grounded on very early stage discussions around HQS, when the notion of “non bank financing” played a particular role. With regard to securitisation, this notion means nothing other than the support of bank lending to their corporate clients via – relatively cheap – refinancing. Accordingly, the opinion prevailed that HQS should be limited to senior tranches of a securitisation transaction. Indeed, the potential benefits generated by securitisation are far more multi-layered than that; in addition to refinancing, the benefits of securitisation particularly include balance sheet structure management (i.e. Leverage Ratio) as well as capital management, both of which are crucial limiting factors for bank lending.

With the current long-lasting low interest rate environment and ample liquidity provisioning to the market (i.e. via LTRO), the aforementioned additional factors dominate the determination of the scope for lending. This is particularly true with regard to peripheral Member States. Subsequently, the notion of HQS swiftly expanded in order to include the important aspect of risk transfer. However, all considerations remained limited nonetheless to True Sale securitisations and excluded their synthetic peer.

This exclusion comes as a surprise, since synthetic securitisations have already been used in the past to a considerable extent and possess a proven and solid track record as an efficient tool for risk transfer and capital management⁷. The default counterargument used by supervisory authorities has always been the supposedly higher degree of complexity of synthetic securitisations. From the authors' point of view, the reluctance of supervisors as well as reservations in the public opinion are to a large extent due to a lack of differentiation. This perception shall be put into perspective in the following paragraphs of this article.

3. Balance Sheet versus Arbitrage Transactions

In principle, securitisations have to be distinguished according to their underlying motivation between balance sheet and arbitrage transactions. With a **balance sheet transaction** the originator intends to refinance balance sheet assets via the capital market and/or to transfer the credit risk which stems from loans and loan commitments to the capital market, in order to manage the balance sheet structure and/or his capital. In the case of a synthetic securitisation, the motivation to achieve risk transfer and capital relief prevails. Stated more plainly, one could call this transaction type „real economy driven“, since lending and securitisation are interdependent.

Arbitrage transactions are motivated by the originator's intention to generate a profit in the sense of an interest margin and to provide investors with financial instruments featuring

⁷ There are no robust statistics about the synthetic securitisation market with all its different segments. Therefore we confine our analysis to synthetic balance sheet transactions where KfW has acted as intermediary, hence the market segment which reflects according to the prevailing opinion the biggest share of synthetic European balance sheet transactions. The total volume of synthetic securitisations amounts to 125 billion Euro. As regards SME loans, since establishment of the KfW PROMISE platform (PROMISE = “Promotional Mittelstand Loan Securitisation”) in 2000, the credit risk stemming from roughly 68.000 SME loans with a total volume of 34 billion Euro has been transferred to the capital market.

targeted interest margins and risk return profiles. There is no close interdependence between a bank's core lending business, or so to say the real economy, and a securitisation transaction. The credit risk underlying a securitisation transaction will usually be especially composed in order to be securitised (i.e. as a portfolio of corporate CDS), and the transaction structure generally will be designed to match investors' risk appetite. Arbitrage transactions boomed in the run-up to the 2007/2008 crisis. Key parameters in order to achieve an "attractive" yield are, on the one hand, the riskiness of the securitised portfolio and, on the other hand, the degree of leverage as well as the incorporation of optional components and market price risk into the transaction structure.

Inglorious textbook examples for the aforementioned type of instruments are synthetic resecuritisations of US Subprime RMBS, as well as "Collateralized Synthetic Obligations" (CSO), which are based on a portfolio of CDS referencing corporates, banks or sovereigns. Last but not least, and presumably hitting rock bottom of financial engineering, "Constant Proportion Debt Obligations" (CPDOs) have to be mentioned, which enabled investors to bet on specific trading strategies.

Unfortunately, the public perception and press coverage of synthetic securitisation are dominated by these arbitrage instruments, driven particularly by their extremely poor performance, which is reflected in rating downgrades, defaults and realized losses.

4. Excellent performance of synthetic balance sheet securitisations

Due to this overall negative perception, the proven quality of synthetic balance sheet securitisations, their usefulness for investors and originators and their use as an instrument of promotional policy has been somewhat forced into the background. As a result, successful high-quality synthetic balance sheet securitisations, such as those of the KfW platforms PROMISE and PROVIDE, have so to say been "collectively punished" for the poor performance of synthetic arbitrage securitisations.

The following evaluation of transactions, in which KfW had the role of an intermediary, serves as proof for the excellent historic performance of synthetic balance sheet transactions. The evaluated transactions have a total volume of 125 billion euros and were issued between 2000 and 2009. They include all PROMISE transactions (SME loans), all PROVIDE transactions (RMBS) and certain other transactions with a similar structure. The cumulative defaults and the cumulative realised losses in the securitised portfolios have, with a few exceptions, been very low.⁸ The cumulative realised losses (net losses from defaulted loans after work-out taking into account recoveries and enforcement costs) were on average considerably less than 0.5% of the original transaction volume, see the following Figure 1.

⁸ The majority of these transactions have now ended and been repaid.

Figure 1: Performance of synthetic securitisations with KfW transactions as an example

No.	PROMISE (SME)	Bloomberg-Ticker	Year	Original transaction volume (mEuro)	Originator	Cumulative credit defaults (in % of original balance)	Cumulative realised losses (in % of original balance)
1	Promise-I 2000-1 plc	PROMS I00-1	2000	2,524	IKB	4.08%	0.43%
2	Promise-A 2000-1 plc	PROMS A00-1	2000	1,000	HVB	3.00%	0.00%
3	Promise-K 2001-1 plc	PROMS K01-1	2000	1,000	Dresdner Bank	0.52%	0.06%
4	Promise-Z 2001-1 plc	PROMS Z01-1	2000	1,000	DZ BANK	2.54%	1.52%
5	Promise-G 2001-1 plc	PROMS G01-1	2001	650	BW Bank	0.29%	0.11%
6	Promise-I 2002-1 plc	PROMS I02-1	2002	3,650	IKB	3.70%	0.15%
7	Promise-A 2002-1 plc	PROMS A02-1	2002	1,618	HVB	2.02%	0.01%
8	Promise-C 2002-1 plc	PROMS C02-1	2002	1,500	Commerzbank	0.61%	0.03%
9	Promise Austria-2002 plc	PROMS AU02-1	2002	1,007	Bank Austria CA	0.95%	0.02%
10	Promise Color 2003-1	PROMS COL-03	2003	1,133	HVB	3.90%	0.95%
11	Promise XXS-2003-1 plc	PROMS XXS-03	2003	2,153	HVB	1.60%	0.01%
12	Promise Caravela 2004 plc	PROMS CARA	2004	3,500	BCP	1.49%	0.15%
13	Promise-I Mobility 2005-1 plc	PROMS IM05-1	2005	650	IKB	5.51%	0.76%
14	Promise-I Mobility 2005-2 plc	PROMS IM05-2	2005	1,501	IKB	6.84%	0.98%
15	PROMISE-K 2006-1 plc	PROMS K06-1	2006	2,100	Dresdner Bank	0.05%	0.02%
16	Promise-I Mobility 2006-1 plc	PROMS IM06-1	2006	1,700	IKB	5.05%	1.02%
17	Promise XXS-2006-1 GmbH	PROMS XXS-06	2006	4,493	HVB / Bank Austria CA	2.18%	0.83%
18	Promise-I Mobility 2008-1 plc	PROMS IM08-1	2008	1,501	IKB	3.19%	0.47%

No.	PROVIDE (RMBS)	Bloomberg-Ticker	Year	Original transaction volume (mEuro)	Originator	Cumulative credit defaults (in % of original balance)	Cumulative realised losses (in % of original balance)
1	Provide-A 2001-1 plc	PROVI A01-1	2001	1,000	HVB	2.31%	0.34%
2	Provide Home 2001-1 plc	PROVI H01-1	2001	1,548	Aareal Bank	n/a (aggregated)	0.02%
3	Provide Blue 2002-1 plc	PROVD 2002-1	2002	1,300	BHW	4.47%	0.22%
4	Provide Gems 2002-1 plc	PROVI G02-1	2002	1,052	Rheinhyp	n/a (aggregated)	3.20%
5	Provide Residence 2002-1 plc	PROVI R02-1	2002	1,508	Commerzbank	n/a (aggregated)	0.07%
6	Provide Comfort 2002-1 plc	PROVID C02-1	2002	3,006	Hypo Real Estate	n/a (aggregated)	0.03%
7	Provide Home 2002-1 plc	PROVI H02-1	2002	1,821	Aareal Bank	5.25%	0.01%
8	Provide-VR 2002-1 plc	PROVI VR02-1	2002	623	DG HYP	6.49%	2.68%
9	Provide Blue 2002-2 plc	PROVD 2002-2	2002	1,655	BHW	2.53%	0.02%
10	Provide Residence 2002-2 plc	PROVI R02-2	2002	1,511	Commerzbank	n/a (aggregated)	0.02%
11	Provide Blue 2003-1 plc	PROVD 2003-1	2003	1,947	BHW	2.18%	0.02%
12	Provide Residence 2003-1 plc	PROVI R03-1	2003	1,528	Commerzbank	n/a (aggregated)	0.01%
13	Provide Green 2003-1 plc	PROVG 2003-1	2003	1,018	Westdeutsche Immobilienbank	0.55%	0.01%
14	Provide Release 2003-1 plc	PROVI RL03-1	2003	1,750	Eag Banking plc	n/a (aggregated)	0.00%
15	Provide-A 2003-1 plc	PROVI A03-1	2003	3,100	HVB	n/a (aggregated)	0.09%
16	Provide Orange 2003-1 B.V.	PROVO 2003-1	2003	1,000,000	NIB Capital	4.26%	0.20%
17	Provide Domicile 2003-1 plc	PROVI D03-1	2003	1,972	Postbank	1.03%	0.00%
18	Provide-VR 2003-1 plc	PROVI VR03-1	2003	449	DG HYP	5.43%	2.30%
19	Provide-A 2004-1 plc	PROVI A04-1	2004	3,500	HVB	n/a (aggregated)	0.05%
20	Provide Lowlands 1 B.V.	PROVL-1	2004	1,000	SNS	1.21%	0.00%
21	Provide Blue 2004-1 plc	PROVD 2004-1	2004	2,176	BHW	0.39%	0.03%
22	Provide Casa 2004-1	PROVI CA04-1	2004	1,040	AHBR	1.33%	0.02%
23	Provide-VR 2004-1 plc	PROVI VR04-1	2004	500	DG HYP	3.75%	0.86%
24	Provide MLF 2004 plc	PMLF 2004	2004	241	(CFF) Credit Foncier de France	1.04%	0.05%
25	Provide Graphite 2005-1 plc	GRAPH 2005-1	2005	1,858	Northern Rock	1.66%	0.24%
26	Provide Blue 2005-1 plc	PROVD 2005-1	2005	1,400	BHW	3.54%	0.50%
27	Provide Blue 2005-2 plc	PROVD 2005-2	2005	3,901	BHW	3.55%	0.48%
28	Provide-A 2005-1 plc	PROVI A05-1	2005	4,778	HVB	1.43%	0.07%
29	Provide Bricks 2005-1 plc	PBRIX 2005-1	2005	2,997	Realkredit Danmark A/S	n/a (aggregated)	0.02%
30	Provide Graphite 2005-2 plc	GRAPH 2005-2	2005	1,735	Northern Rock	2.34%	0.41%
31	Provide Graphite 2006-1 plc	GRAPH 2006-1	2006	2,153	Northern Rock	3.29%	0.67%
32	Provide-A 2006-1 GmbH	PROVI A06-1	2006	2,903	HVB	1.54%	0.06%
33	Provide Bricks 2007-1 plc	PBRIX 2007-1	2007	4,000	Realkredit Danmark A/S	n/a (aggregated)	0.01%
34	Provide Domicile 2009-1	PROVI D09-1	2009	1,534	Postbank	1.37%	0.04%

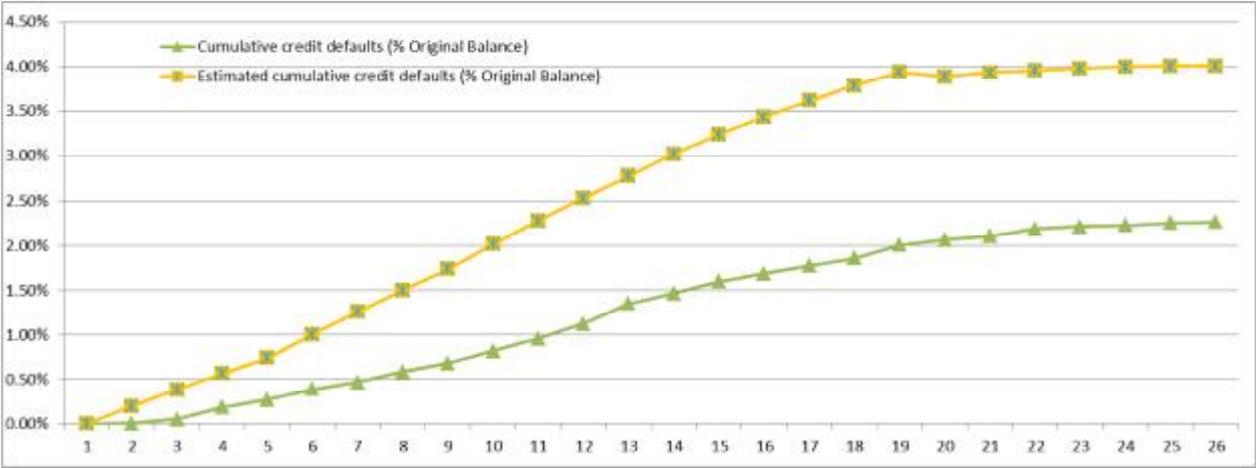
No.	Other transactions	Bloomberg-Ticker	Year	Original transaction volume (mEuro)	Originator	Cumulative credit defaults (in % of original balance)	Cumulative realised losses (in % of original balance)
1	Symyonie 2004-1 plc	SYMV 2004-1	2004	200	National Bank AG	2.70%	0.00%
2	Seas 2005-1 plc	SEAS 2005-1	2005	650	IKB	0.15%	0.22%
3	Roof Cee 2006-1 plc	n/a	2006	450	Raiffeisenbank International	2.86%	0.12%
4	Process Home 2003 plc	PRCSS 2003	2003	1,524	Aareal Bank	4.95%	0.00%
5	Proscore-VR 2005-1 plc	PROVR 2005-1	2005	735	DG HYP	5.04%	0.79%
6	primus MULTHAUS 2006 GmbH	MULTH 2006	2006	383	Nord LB	0.00%	0.00%
7	Stability CMBS 2007-1 GmbH	STAB 2007-1	2007	909	IKB	7.42%	0.42%
8	Prime Bricks 2007-1	PBRIX 2007-1	2007	4,498	Realkredit Danmark S/A	n/a (aggregated)	n/a (aggregated)
9	R-Estate Germany - 6	REGER 2007-6	2006	4,615	Hypo Real Estate	0.00%	0.12%
10	Mortgage Loans France 2007	n/a	2007	3,766	CFF (Credit Foncier de France)	0.75%	0.02%
11	Prime Bricks 2008-1	PBRIX 2008-1	2008	1,495	Realkredit Danmark S/A	n/a (aggregated)	n/a (aggregated)
12	EPIC plc	ESSEN 1	2004	374	Depfa Bank	0.00%	0.00%
13	Stichting PROFILE Securitisation I	PROFLI	2006	373	Sumitomo Mitsui Banking Corp Europe / NIBC	0.00%	0.00%
14	EPIC 2 plc	ESSEN 2	2006	718	Depfa Bank	0.00%	0.00%
15	Smart PFI 2007	SMPFI 2007-1	2007	389	Sumitomo Mitsui Banking Corp Europe	0.00%	0.00%
16	EPIC 3 plc	ESSEN 3	2008	666	Depfa Bank	0.00%	0.00%

Source: Investor Reports, Offering Circulars

If one compares the actual loan default rates in the portfolios of the PROMISE transactions with the expected loan default rates derived from the loan ratings at the time of issue, it becomes clear that the underlying loan-portfolios actually performed considerably better than expected at the time of issue, see Figure 2⁹.

⁹ see in detail Schmidtchen/Cerveny „Performance deutscher Mittelstandsverbriefungen in den Jahren der Krise“, in Kreditwesen 19-2010, page 1020 ff.

Figure 2: Credit Defaults at transaction pool-level within the PROMISE series (actual vs. ex ante estimate)



Source: Investor reports, own representation

5. Structural simplicity, transparency and security of synthetic balance sheet transactions

5.1 Simplicity of synthetic balance sheet securitisations

True sale securitisations carried out by banks are based on the sale of a receivables portfolio. Even the simplest true sale securitisation typically requires (1) the establishment of a special purpose vehicle (SPV) together with the related corporate administration agreements, (2) the sale and the insolvency proof transfer of the receivables and any collateral to the SPV, (3) the financing of the purchase of the receivables through the issue of several classes of securities (ABS) by the SPV, under which payments are to be made from the income of the SPV pursuant to a priority of payments (4) an interest rate swap entered into by the SPV to hedge its interest rate risk resulting from fixed rate interest income from the portfolio and floating rate interest liabilities under the ABS, (5) the appointment by the SPV of a servicer who administers, collects and enforces the receivables and forwards the collected monies to the SPV, (6) the opening and maintenance of bank accounts by the SPV, (7) the appointment by the SPV of a cash administrator who applies the income of the SPV towards its payment obligations, (8) the appointment of a paying agent by the SPV in respect of the ABS, (9) the appointment by the SPV of a security trustee to whom the portfolio and all other assets of the SPV are charged or transferred for collateral purposes to secure the obligations of the SPV under the ABS and all other transaction documents, as well as (in many cases) (10) the provision of a liquidity facility to the SPV and (11) the appointment of a data protection trustee who is entrusted with encrypted personal data regarding the securitised receivables.

In contrast, synthetic balance sheet securitisations carried out by banks are based on the equally simple and traditional principal of a cash collateralised loss guarantee.¹⁰ In its simplest form it consists of a loss guarantee granted by the investor to the bank, which is secured by a cash deposit made by the investor with the bank. In most cases, the loss guarantee and the cash collateral are combined in a single instrument. This instrument is a note which is issued by the bank and the terms of which contain the loss guarantee. Under the terms of the note, any amounts due under the loss guarantee are deducted from the outstanding principal amount of the note (just as these amounts would be deducted from the deposit in the aforementioned case of a loss guarantee secured by a cash deposit). As these notes are characterised by the embedded guarantee, we will refer to these notes as “guarantee notes”.¹¹

The fundamental structure of a synthetic balance sheet securitisation thus consists of a note issued by a bank with an embedded loss guarantee. It requires neither an SPV nor the multiple services and service contracts necessary in a true sale securitisation. Synthetic balance sheet securitisations are therefore much less complex than corresponding true sale securitisations.

This is true regardless of whether the note or cash deposit owed by the bank is secured (e.g. by covered bonds or sovereign bonds). The combined risk from a loss guarantee and a bank deposit or note is neither complex nor opaque. A bank investing in a guarantee note must separately hold regulatory capital both for the credit risk of the portfolio and the additional credit risk of the bank. The additional credit risk of the bank does not in any way affect the securitisation risks (model risk, agency risk, legal risk and operational risk) with which law makers justify the regulatory capital surcharge for securitisation exposures. Hence, any surcharge for securitisation exposures in respect of a guarantee note must be the same whether the note is secured or unsecured.

Occasionally one hears that synthetic balance sheet securitisations are complex because the embedded loss guarantee often contains extensive terms. It has also been suggested that these transactions carry more risk than true sale transactions because in a synthetic transaction the risk of the investor largely depends on the terms of the loss guarantee. The question is, how any other contract or commercial transaction is any different in that respect. One could just as well say that loans are complex and dangerous because loan contracts (for example LMA standard contracts) may contain complex and extensive provisions and the risk of the parties depends largely on the content of the contract itself. And, of course, the documentation of any true sale securitisation is extensive and its contents may, in addition to the legal, operational and credit risks inherent in a true sale structure, create all sorts of additional risk for the investor. Hence, both objections prove to be unsustainable when looked at more closely.

¹⁰ Typically, the loss guarantee provides for a retention by the originator of first losses up to a certain amount and a maximum amount of losses covered by the guarantee. This is what makes it a securitisation from a regulatory point of view.

¹¹ Notes with an embedded credit default swap or loss guarantee are commonly called “credit-linked notes”. This term was coined for derivative products. Together with the attribute “synthetic” it contributes to the inaccurate perception that a cash collateralised loss guarantee is a complex and novel structure. To avoid such misperception, the term “guarantee notes” (or “loss guarantee notes”) should be used for notes with an embedded loss guarantee.

Synthetic balance sheet securitisations are almost invariably done to obtain regulatory capital relief. Accordingly, the structure of the embedded loss guarantee and the risks transferred thereunder are determined by the applicable regulatory minimum requirements. For economic reasons, the extent to which risks are transferred to the investor is usually limited to the regulatory minimum requirement. In fact, most provisions in a synthetic balance sheet securitisation are included in the interest of investors in order to define the specific credit risk they assume and to exclude any other risks such as legal and operational risks, e.g. from the invalidity of the receivables or improper servicing.

The mechanism of the loss guarantee is very simple: a loss which the bank has suffered in respect of a receivable may only be deducted from the outstanding principal amount of the guarantee notes if certain conditions are met. These conditions include that the receivable complies with the agreed eligibility criteria, that the loss does not result from improper servicing and that no further recoveries are to be expected on the receivable. A further condition that is often agreed upon in the interest of the investor is that the guarantee may only be drawn through a reduction of the principal amount of the notes if an independent auditor, mostly a certified accountant, examines the compliance with the aforementioned conditions and confirms that there is no reason to believe that the loss is due to any non-compliance with such conditions. As this loss audit has become a standard feature of synthetic balance sheet securitisations, all references to these transactions in the following discussion will assume the inclusion of this feature.

Also in the interest of the investor, the payment obligations of the bank under the guarantee notes are often secured by collateral. In many past transactions the collateral consisted of covered bonds (*Pfandbriefe*) and in all PROMISE and PROVIDE transactions the collateral consisted of debt obligations of KfW. In the case of secured guarantee notes it is sometimes necessary for legal or other reasons to use an SPV which issues the guarantee notes, uses the proceeds to purchase the collateral and grants a loss guarantee to the originating bank which mirrors the loss guarantee embedded in the guarantee notes. It should be noted that these SPV structures are still much less complex than a corresponding true sale securitisation. In particular, the legal and operational complexity arising from the sale and assignment of the receivables and any related collateral to the SPV, the collection thereof on behalf of the SPV and the transfer and hedge of the related cash flows does not arise in synthetic SPV transactions.

5.2 Transparency of synthetic balance securitisations

Transparency with regard to information concerning the portfolio and the originator does not depend on whether the transaction is a true sale or a synthetic transaction. However, the transparency of the transaction structure and the risks resulting from it differ in the two securitisation types. The less complex *transaction structure* and documentation of synthetic balance sheet securitisations makes them *per se* more transparent than equivalent true sale securitisations. In addition, the *risks* assumed by the investor in synthetic balance sheet securitisations are in general more transparent than in true sale securitisations.

In true sale securitisations, in addition to the credit risk of the securitised receivables portfolio, all further legal, economic and operational risks which result from the purchase and administration of the portfolio lie, in the first place, with the SPV (and thus indirectly with the investor). These risks include the risk that (1) the securitised receivables are invalid or not

enforceable (validity risk), (2) the purchase of the receivables is invalid or not insolvency proof (transfer and clawback risk), (3) the receivables are extinguished by set-off against a claim of the debtor against the originator (set-off risk), (4) monies collected by the servicer are not paid on to the SPV (commingling risk), (5) losses resulting from the improper servicing of the receivables (servicing risk), (6) in an insolvency of the originator, where the originator is acting as servicer, the servicing is interrupted or deteriorates (servicer replacement risk), and (7) in an insolvency of the originator, where the originator is acting as swap counterparty, there is no substitute hedge for the mismatch between interest income and liabilities (swap counterparty replacement risk). While the contracts between the SPV and its various counterparties provide for an indemnification of the SPV if these risks materialize, the recoverability of such indemnification is subject to legal, litigation and insolvency risks. The complexity and diversity of these risks, in addition to the abovementioned complexity of the legal structure and documentation, have an adverse effect on the transparency of true sale securitisations.

In synthetic transactions the investor carries two clearly identifiable risks: (1) the credit risk of the securitised receivables and (2) either, in the case of unsecured guarantee notes, the credit risk of the bank issuing the guarantee notes or, in the case of secured guarantee notes, the credit risk of the collateral (i.e. *Pfandbriefe*, KfW debt etc.). The investor does not carry the additional risks of a true sale securitisation described above. The reason for this is that, on the one hand, some of these risks do not arise in the first place due to the structure of the transaction (e.g. transfer and clawback risk, commingling risk, set-off risk, servicer replacement risk, swap counterparty replacement risk). On the other hand, under a guarantee note the investor primarily has a claim for the full payment of principal and interest. The outstanding principal amount of the guarantee note may only be reduced by the amount of a realised loss in respect of a receivable if and to the extent that (1) such loss is not due to risks that are to be carried by the bank and (2) this is confirmed by an independent auditor. Hence the outstanding principal amount of a guarantee note may not be reduced because of losses caused by inadequate servicing or any breach of the agreed eligibility criteria in respect of the securitized receivables. Therefore, apart from the greater structural transparency of guarantee notes, the risks which they present to investors are also more transparent than those in corresponding true sale transactions.

5.3 Risk profile of secured guarantee notes

In all 68 synthetic securitisations where KfW acted as intermediary, the guarantee notes have been secured by KfW debt obligations and in the majority of all other synthetic balance sheet securitisations, at least in Germany, the guarantee notes have been secured by AAA rated covered bonds. Where the guarantee notes are secured by high quality collateral, there is considerably less risk for the investor arising out of the transaction structure than in corresponding true sale transactions. As described in 5.2, true sale transactions give rise to a range of undesired legal and operational risks which mainly materialise in an insolvency of the originator (validity risk, transfer and clawback risk, set-off risk, commingling risk, servicing risk, servicer replacement risk and swap counterparty replacement risk). These risks do not arise in secured guarantee note transactions. Losses may not be deducted from the principal amount of the guarantee notes to the extent that an independent audit reveals (in hindsight, which is particularly safe for investors) that the losses are due to a breach of any eligibility criteria, servicing standards or other contractual requirements for the allocation of such

losses. Furthermore, in the case of an insolvency of the originator, the bonds become due and are redeemed from the relevant collateral.¹²

6. High-quality synthetic securitisations

Currently, synthetic balance sheet securitisations entered into to free up regulatory capital and thus the scope for lending, are generally done on a bilateral basis without an external rating. This has, amongst others, the following implications: (1) usually there is no external rating for cost reasons, (2) the originator uses a supervisory formula approach (SFA) as proof of significant risk transfer, (3) the protection seller or investor is generally not a bank or insurance company but rather a specialised credit fund or other investor with less or no regulatory restrictions, (4) the market is relatively small measured by the number of participants and, for those not directly involved, not transparent, (5) on the side of the protection seller, the market is quite highly concentrated, (6) on the side of originators seeking capital relief, access to the market is difficult or impossible where originators have little or no familiarity with the instrument and are too small to be approached by protection sellers, (7) there are no apparent starting points to convert the market back to a more open and more widely diversified market in the medium- or long-term as long as the regulatory treatment of synthetic balance sheet securitisations remains unchanged.

This situation could be solved by an appropriate standardisation of transaction structures, the introduction of specific criteria that synthetic securitisations need to fulfil and finally the qualification of synthetic balance sheet securitisations as “High Quality Securitizations” and the creation of an adequate regulatory framework. Due to their excellent historic performance and their structural simplicity, transparency and security, synthetic balance sheet securitisations should for these purposes be treated at least on an equal footing with equivalent true sale securitisations. Following these adjustments, synthetic balance sheet securitisations could make a valuable contribution to the successful implementation of the European Capital Markets Union.

This article reflects the opinion of the authors and is not a statement of Hengeler Mueller or KfW.

¹² Even if, other than in previous synthetic balance sheet securitisations, the terms of the guarantee notes were to foresee that in the insolvency of the originator the guarantee notes are not redeemed and the credit protection remains in place, the performance of the guarantee notes would not be affected by any disruption of or decline in the servicing resulting from the insolvency, as payments on the notes are made from the collateral (and not the portfolio income) and any non-compliance with applicable servicing standards would prevent the deduction of losses from the note principal.