European Synthetic Securitisation

DBRS European Structured Finance Monthly Teleconference Series

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Synthetic Securitisation

Reasons banks consider synthetics:

- Drive for increased regulatory capital
  - Basel III
    - NSFR, LCR, risk weight floors, equity capital ratios, etc.
  - TLAC & MREL
  - IFRS 9

- Support for increased lending to SMEs
  - Or other lending initiatives (Credit Agricole's green securitisation)

- Avoid going cap in hand to capital markets
  - Reduce RWA
  - Divest
  - Or change credit quality of assets held

- Investor demand
  - Looking for higher yields and private deals (regulatory treatment)

Bespoke Nature

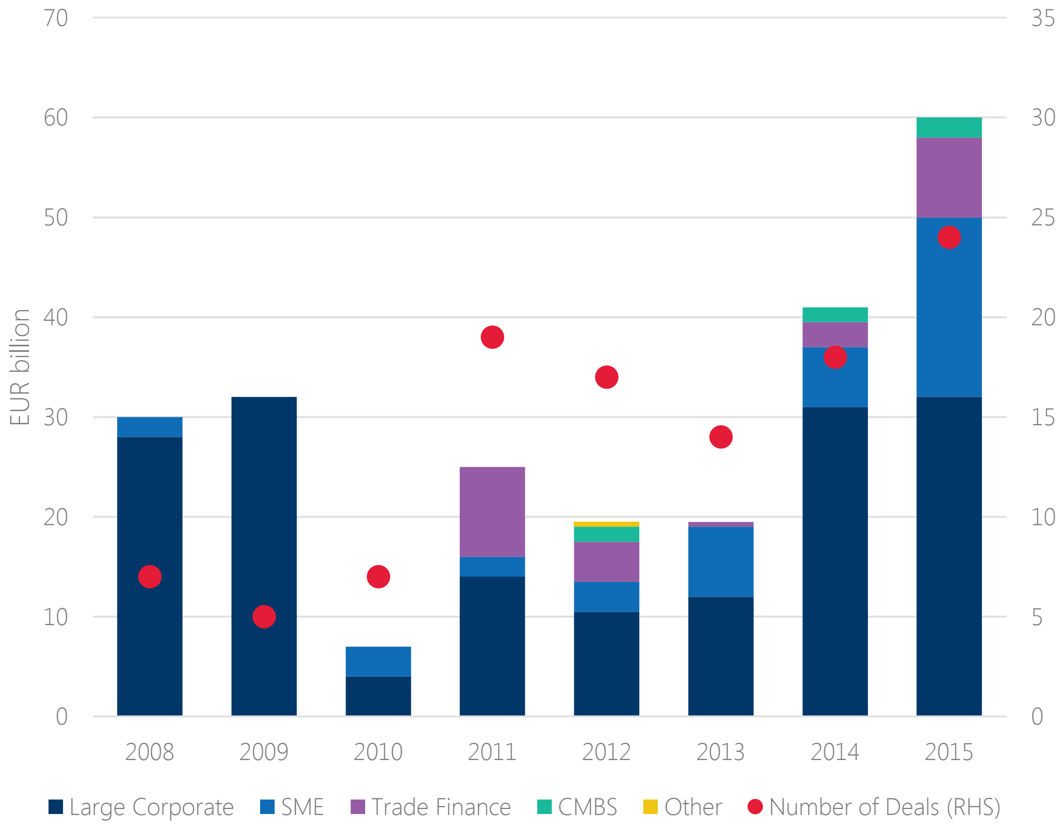
- Cost of capital varies – need to weigh options
  - Issue bonds?
  - New equity (rights issue)?
  - Retail Capital?
  - True Sale Securitisation?
  - Synthetic?

- Ability to transfer assets
  - Variable regulations about transfer of loans

- Regulatory shortfall
  - Size
  - Nature of balance sheet
  - Local regulator

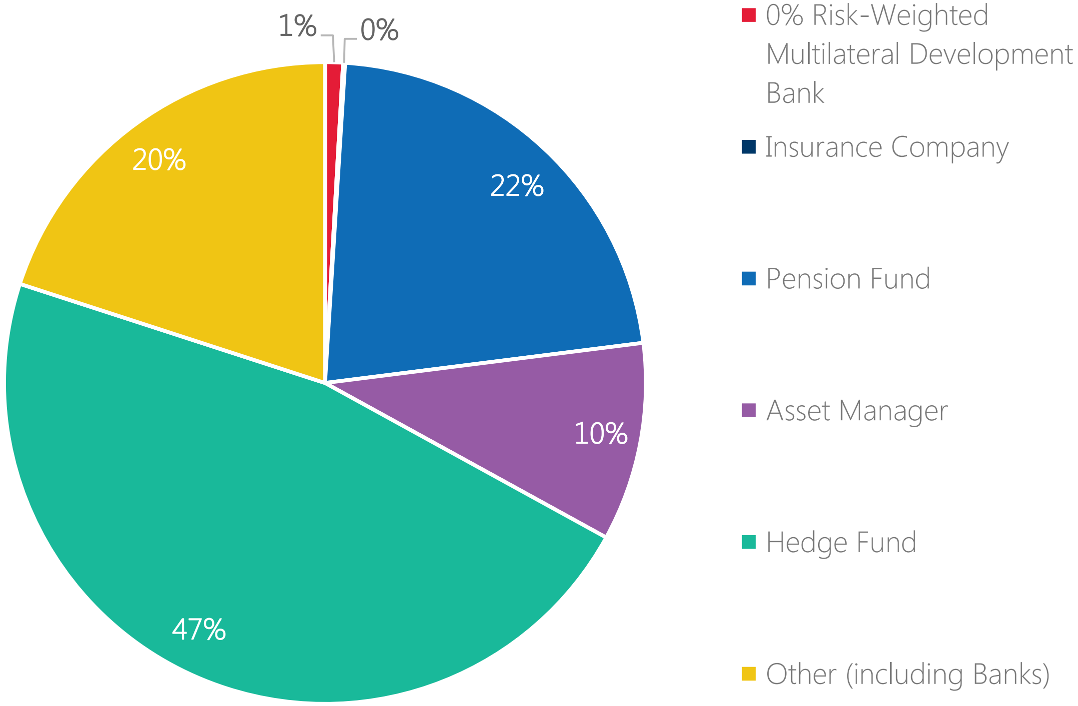
Synthetic Securitisation

Growth in Private Market, by Collateral, 2008-2015

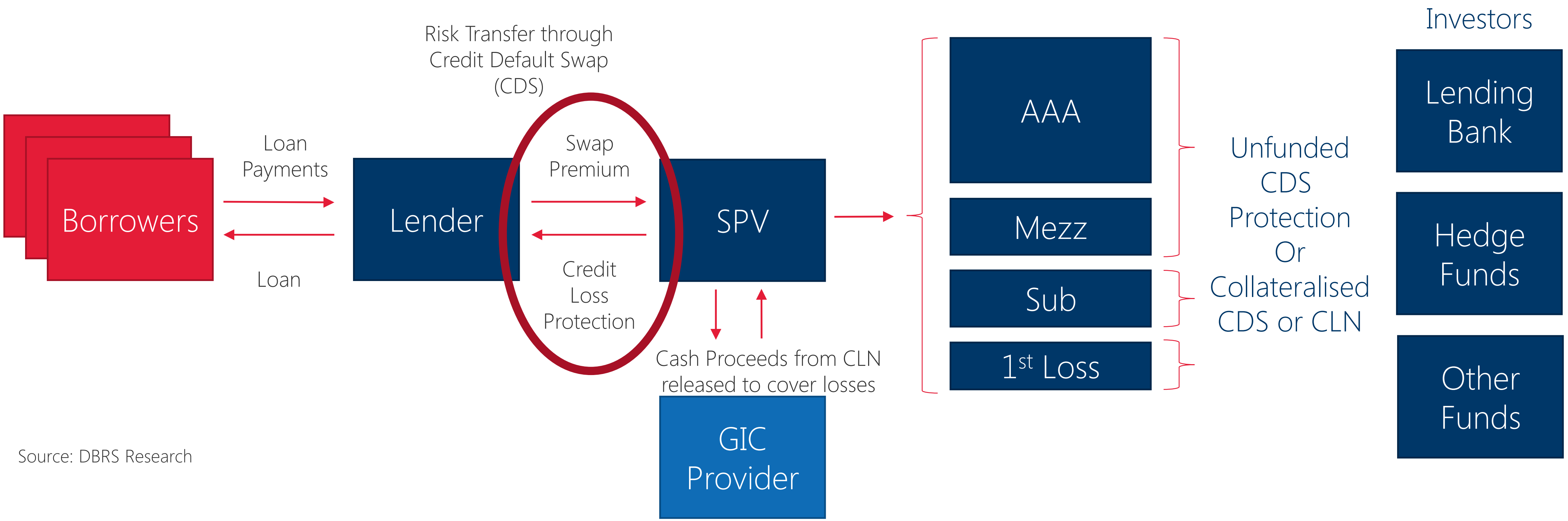


Source: EBA, IACPM and DBRS Research

Synthetic Securitisation Investor Type



Synthetic Securitisation



Source: DBRS Research

Definition of synthetic securitisation as per Article 242(11) of the CRR

Synthetic securitisation means a securitisation where the transfer of risk is achieved by the use of credit derivatives or guarantees, and the exposures being securitised remain exposures of the originator institution.

Comparison: True Sale vs Synthetic Securitisation

True Sale Securitisation

- Main Purpose:
  - Funding and releasing capital for re-investment (assuming risk transfer)
- Collateral:
  - Full transfer to bankruptcy remote SPV ("true sale")
  - Type ranges from consumer loans, to mortgages, to auto loans, to credit card balances, to other regular cash flowing assets
- Cash Flows
  - Underlying collateral provides cash flows to the SPV/issuer, which are in turn paid to investors as per the waterfall
  - Collateral losses can result in note write-downs (reverse sequentially)

Synthetic Securitisation

- Main Purpose:
  - Transferring risk off-balance sheet and releasing capital
  - With SPV or without SPV
  - Can be collateralised to mitigate counterparty risk the bank faces
- Collateral:
  - Remains on bank balance sheet with synthetic risk transfer to an SPV or directly to the investor
  - Typically more corporate risk exposures (SME and middle-market loans)
- Cash Flows
  - Credit default swap and potentially note collateral for CLN provides cash flows to the SPV/issuer, which are in turn paid to investors as per the waterfall
  - Note collateral or the investor reimburses bank in case of collateral losses

Tranched Cover Transactions

The Basel II framework defines “tranched cover” transactions as follows (page 63 of the BCBS128 paper):

“Where the bank transfers a portion of the risk of an exposure in one or more tranches to a protection seller or sellers and retains some level of risk of the loan and the risk transferred and the risk retained are of different seniority, banks may obtain credit protection for either the senior tranches (e.g. second loss portion) or the junior tranche (e.g. first loss portion). In this case the rules as set out in Section IV (Credit risk – securitisation framework) will apply.”

Source: European Banking Authority and DBRS

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Transfer the credit risk of a portfolio through Tranched Cover techniques

Funded Credit Risk Mitigation Instruments	Unfunded Credit Risk Mitigation Instruments
An investor deposits cash into an account of the originating bank to cover losses in relation to one specific tranche only (typically first loss tranche).	Financial guarantee, written bilaterally between the originating bank and the investor, which usually transfers the credit risk in relation to one specific tranche only (typically a first or second loss tranche).

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Unfunded Credit Risk Mitigation Instruments

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Example

	Seniority (size)	*Risk transferred to:*		
Reference Portfolio	**Senior (85%)**	Retained		**Originating Bank**
	Mezzanine (5%)	unfunded CRM (financial guarantee)		**Guarantor**
	Junior (10%)	20% Retained	80% funded CRM (cash deposit)	**Originator / Investor**

Source: European Banking Authority and DBRS

Tranched Cover Transactions

Why are Tranched Cover Transactions widespread?

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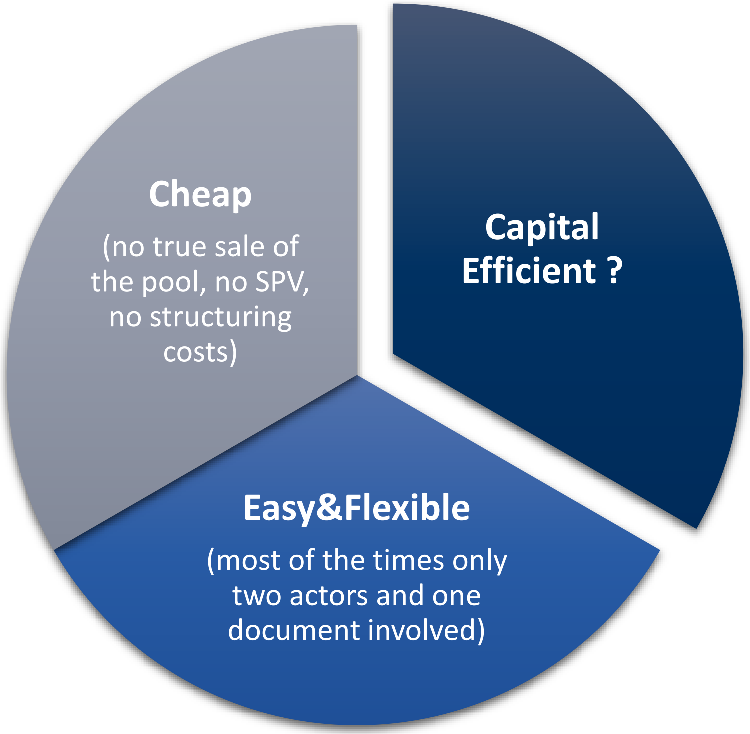

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Tranched Cover Transactions

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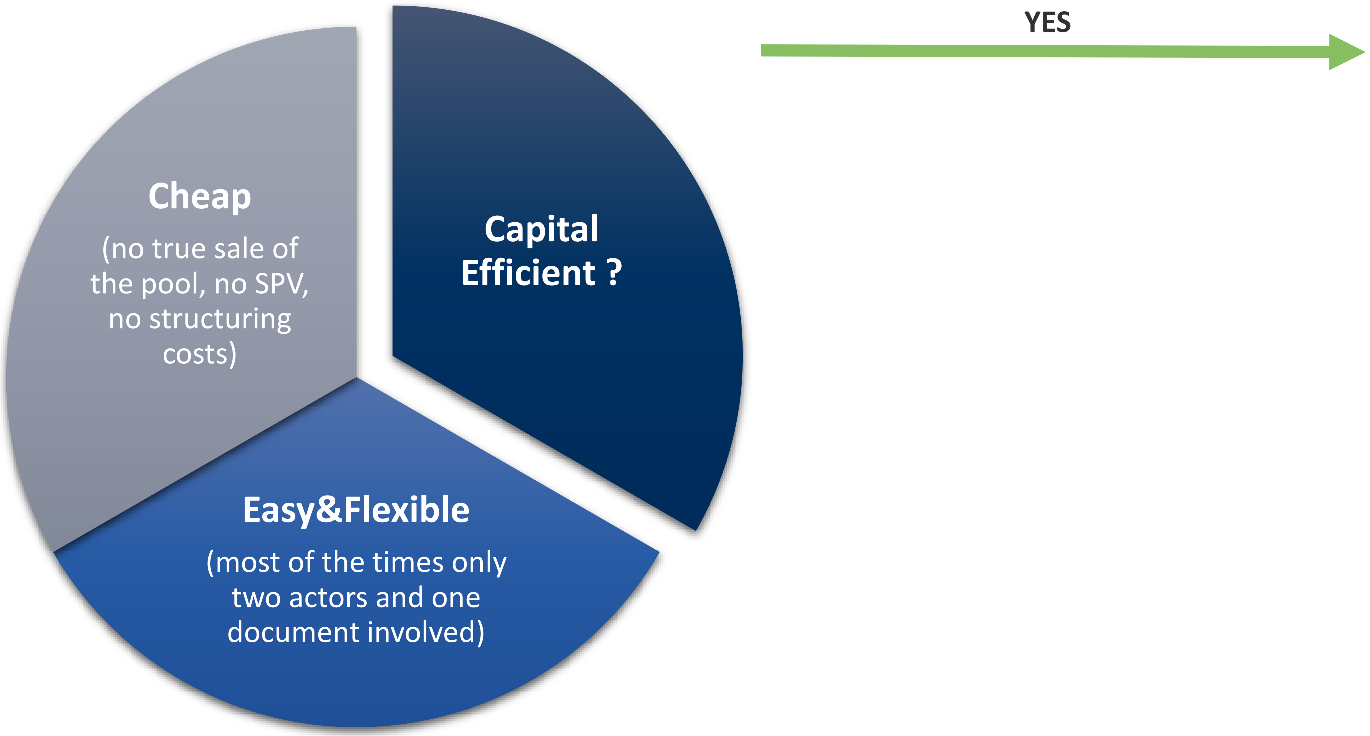

AIRB banks provided that they meet the retention rules and pass the supervisory test of the SRT, are allowed to use the supervisory formula (SFA) of the CRR securitisation framework to compute capital requirements of the retained tranches.

The flexibility of the tranched cover makes easier also to meet Investors' needs. The instrument is particularly popular amongst public entities active in fostering lending to SMEs: EIB/EIF (first with a mezzanine financial guarantee facility and more recently with the SME Initiative), Italian regions and mutual credit guarantee consortia (confidi).

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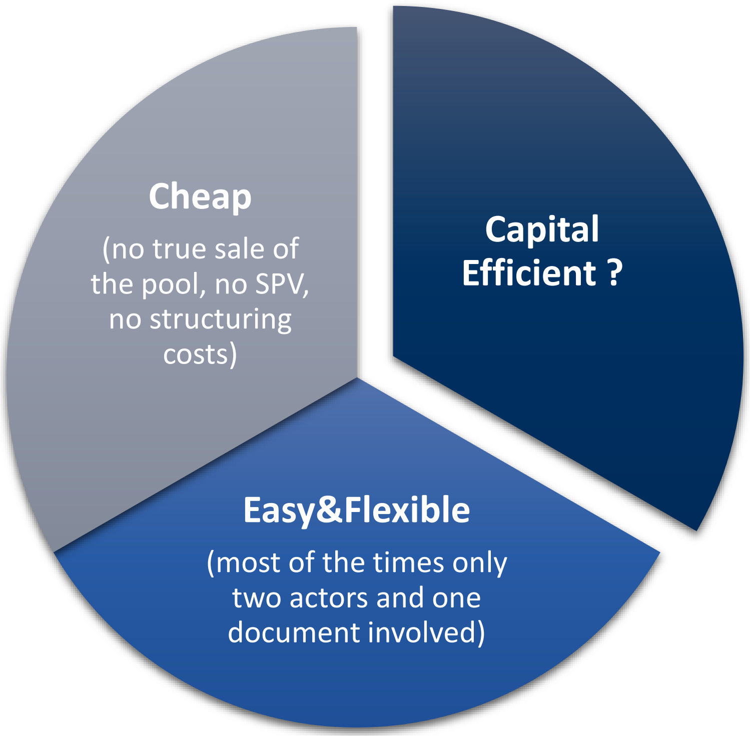

YES

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NO

Standardised banks needs an external assessment from a rating agency on the retained tranches in order to be able to calculate the related capital requirements. **DBRS** has reviewed a number of tranched cover transactions and in all of the cases the assignment of a private or public SF rating was not deemed feasible as many structural and legal elements needed for a rating are usually missing.

Even if **DBRS** was presented with a structure that could potentially have all the characteristics needed for a private or public rating, most likely the ratings would indicate an amount of RWA that would be higher than the one provided by SFA.

Source: European Banking Authority and DBRS

Thank You

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