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Prime Collateralised Securities

STS Newsletter

Prime Collateralised Securities (PCS) is an independent, not-for-profit initiative set up to revitalise the asset-backed securities market in Europe as a key to generating robust and sustainable economic growth for the region.

In addition to being an authorised Third Party Verification Agent under the STS regulation in which capacity it seeks to assist in the success of the STS regime, PCS is also actively involved in educational and advocacy activities in the field of securitisation.

Newsletter

1. Welcome !

Welcome to the second STS Newsletter by PCS keeping stakeholders up to date about market and regulatory developments in the world of STS.

In this edition, in our regular features, we share updated data on the STS securitisation market, our views on the challenges of AUPs (pool audits) in the COVID world and present Martina Spaeth, a member of our analytical team.

In addition to those regular features we have a topical Q&A on the proposed new regulation on synthetic STS transactions. This is not a piece for the experts but a general introduction for those who, notwithstanding an involvement in the securitisation market as a whole, have not encountered synthetics with any degree of proximity. We try to tease out the key issues and the stakes involved in the proposed new rules.

As ever, we very much welcome any feedback on this Newsletter.

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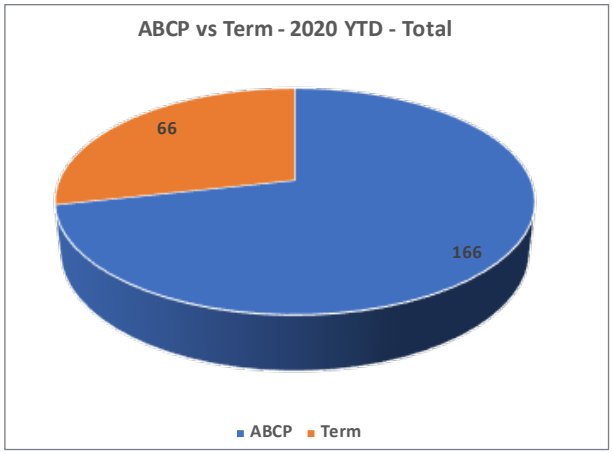
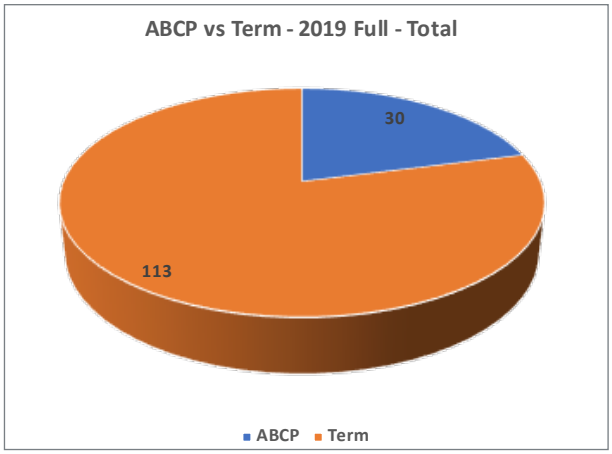
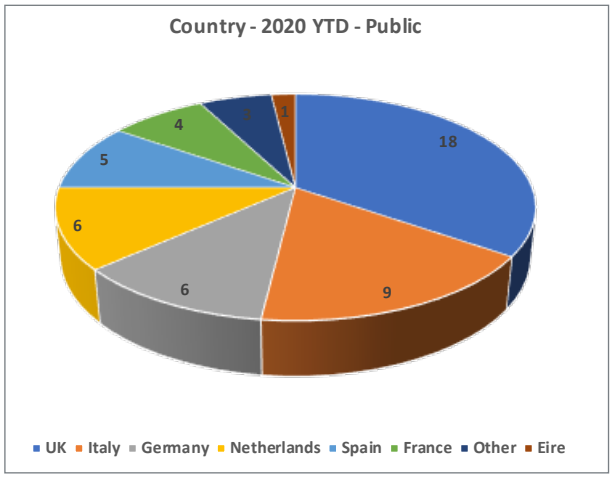
2. Market data

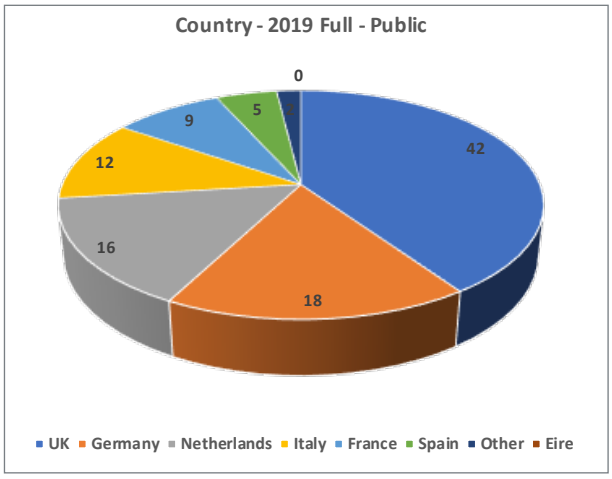
As a regular feature of our newsletter we will publish some statistics regarding the STS market together with a few thoughts as to what these may mean.

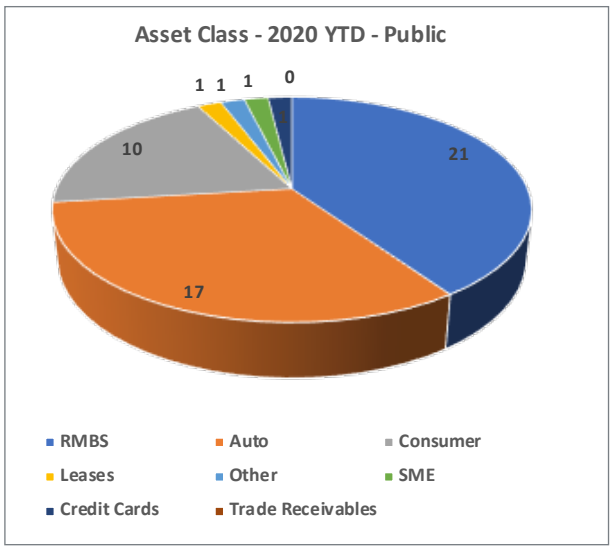
All data from ESMA as of 6 October 2020.

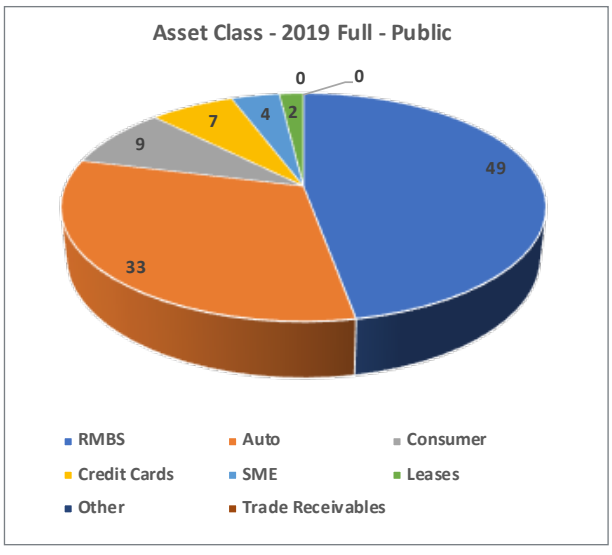












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Commentary:

There is little to add to our last newsletter's commentary. The drop in the number of public transactions both in absolute terms and relative to private (and particularly ABCP) transactions continues apace. Last week alone, out of 22 STS notifications to ESMA, not a single one was a public deal.
However, this does not reflect any diminution of the popularity of STS as a status. It remains the case that virtually all transactions placed with outside investors which can be STS, elect to be so. It does reflect, however, a drop in public issuance across 2020. This drop, in turn, does not reflect investor concerns. Spread levels have broadly returned to pre-COVID levels and in some cases are tighter than they were before March. At 55 bp over EURIBOR, for example, the last Cartesian deal (Dutch RMBS, verified by PCS) priced only 4 basis points wider than their July 2019 issue and had a five times oversubscribed senior tranche. But, despite a keen investor appetite, originators – and particularly large universal banks – are drowning in central bank liquidity and so see little purpose in raising comparatively expensive funds which, due to the COVID triggered slow down, they may not need anyway.

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3. STS and COVID-19 – Agreed Upon Procedures

PCS has been approached to discuss the practicalities of external verification of underlying exposures on numerous occasions.

PCS' analytical approach is based on the STS rules, EBA guidance, historical norms and common sense.

Article 22.2 of the STS rules establishes the requirement for an appropriate and independent party to conduct an accurate verification on the underlying exposures. This is only for term securitisations though as ABCP rules do not require such verification, unless the ABCP programme as a whole is also notified as STS. The EBA guidelines for non-ABCP transactions provide further guidance on pages 19, 44-45 and 77-78. (These guidelines may be found here).

The STS requirements for an external verification are threefold. First the file-to-system check made on a sample of the pool. The number of loans tested is essentially dependent on the combination of the total number of loans in the pool and the confidence level sought. The minimum requirement for STS is a test with a 95% confidence level and a 5% error rate. In fact, almost all securitisations use a higher standard, usually a 99% confidence level and a 1% error rate. The second part of the verification is a check of the transaction eligibility criteria against the loan level data tape. Not all eligibility criteria need to be tested; some criteria are legal concepts that cannot be tested against the loan file. The selection of the criteria to be tested is a common sense judgement of what is relevant and appropriate. We expect this part of the test to have a 100% accuracy rate. The third and final part of the verification is the test of the data appearing in the transaction prospectus data tables. This is required regardless of whether the transaction is public or private although in certain private transactions, this requirement may not be applicable where there is no prospectus and no data tables. Historically, this check has often been based on the established ICMA report format. In any case, we again expect to see a 100% accuracy rate on this last test. We understand that tests on historical data or average life calculations are not required for purposes of article 22.2 of the STS rules although we have seen these tests made on occasions in the past.

Recently we have seen a number of approaches to the challenges posed to the verification process by the COVID-19 lockdown including the use of "remote and virtual" data sites. In all cases, though ways were found to overcome these challenges and an external verification was completed. We were often asked, for example, whether a verification carried out a few months before the sale, but where the transaction was delayed due to Covid-19, could still be used upon market re-opening. PCS' view, based on discussions with lawyers, regulators and market participants, is that as long as the eligibility criteria, the origination and the servicing of the pool are unchanged and the underlying exposures are largely unchanged, a fairly recent pre-Covid-19 lockdown verification may still be used.

4. STS and Synthetic Securitisation

Proposed STS Regulation Changes - A Guide for the Perplexed
We have been asked by stakeholders what was the purpose of the proposed new STS legislation regarding synthetic securitisation and whether (and why) this mattered.

What does the proposed law do?
The proposed law being examined by the European Council and the European Parliament consists of amendments to the current STS Regulation and Capital Requirements Regulation ("CRR").
The first, broadly proposes to extend to synthetic securitisations the possibility of STS status – prohibited in the current regulation – and amends the requirements around retention for securitisations of non-performing loans ("NPLs").

The second extends the benefits provided in the CRR to true sale securitisations to the new STS synthetic securitisations. In other words, banks that hold synthetic STS securitisations can allocate the lower level of capital to those positions as afforded currently only to true sale STS securitisation (and a very limited subset of SME synthetic securitisations under article 270 of the CRR).

Warning: As we will see later, the definition of allowable synthetic securitisations is limited to retained senior tranches.

This Q&A deals only with the synthetic STS part of the proposed changes.

What is a "synthetic" securitisation?
A synthetic securitisation is a financial instrument where an investor takes the risk on a part of a pool of financial assets held on another financial institution's books. Being a securitisation, this risk is tranched so that there is a senior risk, a mezzanine risk and a junior risk (or "first loss") and the investors in each tranche of risk only takes a hit if the investors in the tranches below them have seen their investment completely vanish.

The difference with "traditional securitisation" also known as "true sale" securitisation, is that the assets that are the subject of the securitisation are not sold to a special purpose vehicle and the cash flows from those assets are not allocated to the various securitisation investors.

Basically, a synthetic securitisation is a form of financial insurance. (This is the point, when our friends in the legal community begin to hyperventilate, since – for legal reasons – it is important that synthetic securitisation not be legally an insurance contract. However, this reluctance to call synthetic securitisation an "insurance" product has often resulted in non-experts believing synthetic securitisation to be a mysterious and complex product. It is not. And thinking of it as "insurance" even if it is not technically and legally "insurance" will help to demystify this financial tool).

In a classic synthetic securitisation, the originator (usually called the "protection buyer") has a pool of say 5,000 SME loans. The investor (usually called the "protection seller"), as a mezzanine investor for example, will cover losses between 100 and 800. The first 100 loans to default will not result in any payment. In insurance-land this would be called the "deductible", in securitisation, the "first loss".

Then, for every loan that default after the 100th, the investor will pay the originator an amount equal to the loss suffered. This will go on until the 800th loan. Then, any losses after that will no longer be that investor's problem. (Although they might result in payments by another investor if there is another synthetic securitisation tranche above his or hers.)
In exchange for taking this risk, the investor will receive regular interest payments, which in insurance-land would be called premia.

Weren't synthetic securitisations one of the most terrible products of the great financial crisis?
Yes and no. As with true sale securitisation, synthetic securitisations can be created for legitimate reasons in transparent ways or for speculative reasons in opaque and dangerous forms. The recognition of this fact is the rationale behind the creation in Europe of the STS standard that encapsulates all the simple, transparent and standardized qualities of the classic European securitisations that performed so exceptionally well during the crisis compared to the (usually US) securitisations that did so terribly badly. The current proposals do the same for synthetic securitisation.

The fundamental difference between the extremely destructive synthetic securitisations that played such a deleterious role in the crisis and the securitisations the proposed legislation seeks to define is whether these securitisations are "arbitrage" or "on balance sheet".

As we saw, synthetic securitisations are a form of financial insurance where a bank seeks to insure itself against the risk of losses on its book. This is a sensible and logical step that any person who insures their house or car will recognize.

But, in the years before the crisis, market players decided to use synthetic securitisation effectively to place bets on financial products. Rather than insure loans on their books, these players identified loans and bonds that they had not originated, spotted an arbitrage between the revenue generated and the cost of insurance and, basically, bet on their failure. Sometimes, they would bet multiple times on the failure of the same loan or bond. These players would often, and without the knowledge of the investors, sit down with the originators of these assets to "optimize" the pools the risk of which was sold to investors. This created a totally unmanaged and insidious conflict of interest. These securitisations are called "arbitrage" securitisations. They often used equally flawed US sub-prime securitisations as the risk to be insured and resulted in horrendous losses during the crisis.

These arbitrage securitisations are explicitly forbidden in the definition of synthetic STS securitisations in the current proposals.

On the other hand, traditional synthetic securitisations where a bank legitimately insures against losses on assets it has generated in the normal course of its lending business, have shown an extremely good performance during the crisis as shown by the figures presented by the European Banking Authority (see the data here).

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What is the problem the current legislation seeks to fix?

The current legislative proposal seeks to remedy an anomaly in the capital treatment of assets on which the bank has obtained insurance via a synthetic securitisation. This is an "anomaly" because it is not the result of a desired outcome but of the technical functioning of the CRR.

The CRR requires banks to hold capital for the risk on their balance sheets. After the crisis, the capital required to be held for securitisations became much higher than the capital required for the same assets when not securitized. This was because it was believed the very act of securitisation created new and additional risks ("agency risks"). This had been true of the opaque, conflict of interest riddled, originate to distribute US securitisations that caused so much damage in the financial crisis. The current STS Regulation recognizes though that this was not the case of solid, transparent securitisations.

A bank might use a synthetic securitisation to cover the risks of unexpected losses – the risks for which the CRR requires banks to hold capital. So logic would suggest that, if the risks for which capital is required are legitimately and genuinely removed from a bank's balance sheet, the capital required to be held by that bank should drop commensurately. But, by using a synthetic securitisation to remove that risk, the bank creates a "securitisation". And the senior risk that is not transferred to the synthetic securitisation investor (not "insured" by the bank) now is transformed – for regulatory purposes – into a "securitisation position".

And we have seen that securitisation positions that are not STS require much more capital than the same risk in non-securitised form.

The result is that, as the CRR currently operates, a bank that insures all the risk for which the rules require it to hold capital, may need sometimes even more capital than before it insured that risk.

At the very least, it will receive nowhere near the capital benefit commensurate with the reduction in actual risk. This is because the senior uninsured risk – the risk for which, before the synthetic securitisation was done, no capital is required – is now called a "senior securitisation position" for which substantial capital is required. This is the case even though it is basically the same risk but falling into a different regulatory technical bucket. This results in such an absurdity that the regulators have had to pass a rule saying that you cannot be required to hold **more** capital once you have insured the risk than you had to hold for the same risk without insurance as this could, in some cases, be the outcome.

By allowing well structured synthetic securitisations to be treated as STS, the legislation seeks partially to remedy this result that otherwise disincentivizes banks from reducing risk and thus strengthening the European banking sector as a whole.

Why should we care about this anomaly?

The implementation of the new Basel rules will require European banks to raise huge amounts of additional capital. (For a more detailed analysis, you may read PCS' article on the subject here.

If they cannot raise such capital at a reasonable cost – a certain challenge made yet more steep by the current pandemic - European bank will have no choice but to ration finance to borrowers (companies, SMEs, homeowners and individuals generally.) Since, in contrast with the United States, 75-80% of all finance in Europe is obtained from banks rather than capital markets this will create an artificial constraint on European economic growth, including the continent's recovery from the consequences of COVID-19.

The only alternative to maintaining lending levels, if capital is not forthcoming, is for banks to recycle their existing capital by legitimately removing risk from their balance sheet. Securitisation, including synthetic securitisation, is one of the few tools that can achieve this result.

What is synthetic excess spread and why does it appear to be controversial ?
"Excess spread" is an expression that comes from true sale securitisation. It is a simple concept at heart: the pool of assets securitized generates income (usually in the form of interest). That income belongs to the special purpose vehicle since it has purchased the securitized assets via a true sale. The difference between the income generated by the assets and the costs of the special vehicle – including the interest it has to pay to the securitisation investors - is excess to the needs to the securitisation. That is the "excess spread" – the amount of interest generated by the assets in excess of the total funding costs of the securitisation.

In a true sale securitisation, excess spread is used to cover losses suffered by the securitized pool. This is normal and even necessary. In the normal lending of a bank, a part of the interest received is always meant to cover the expected losses on a pool. If a bank cannot cover the expected losses on its lending from the interest it makes from the non-defaulted loans, it deliberately runs that business at a loss. Therefore, after the assets are securitized, excess spread continues to be used to cover losses as it did before. If the excess spread is greater than the losses suffered, the money is returned to the originator.

In a true sale securitisation, the calculation of the amount of excess spread is exceedingly simple: you see how much cash came in, you deduct the costs paid by the special purpose vehicle. The difference is the excess spread. In a synthetic securitisation though the cash flows do not belong to the vehicle. (There may not even be a vehicle). You can, of course, synthetically recreate this excess spread by stating that a certain amount will be deemed to be excess spread so that the losses suffered on the pool will be reduced by that amount. This legitimately recreates the same mechanism as exists in a true sale securitisation. But the amount of excess spread is not a real identifiable cash amount. It is a number chosen by the originator and investor.

This is why there is some controversy around "synthetic excess spread". Back in the past, some banks seemed to have abused the concept. They did this by entering into a synthetic securitisation which they declared to their regulators had removed credit risk from their balance sheet and through this sought to hold less capital. But they were accused of having chosen a "synthetic excess spread" amount so unrealistically high that it was pretty inconceivable that, once you subtracted from actual losses the huge excess spread number, the supposed investors could ever really suffer loss. These past transgressions made policy makers and regulators wary of synthetic excess spread.

However, the EBA and the Commission were very aware of these risks and so the draft legislation is so framed that it is not possible to declare an unrealistic excess spread and claim STS. The drafting contains a complete solution to the identified risk.

Who does the proposed change help?
First, it helps European banks seeking to use their existing capital for new lending by removing risk from their balance sheet. It will do so by allowing them to still hold capital against the risk but at a more reasonable level.

But it also helps investors who wish to insure bank risk for a return. Under the current proposal – and differently from the rules on true sale STS securitisation – only the bank issuing a synthetic securitisation and holding the senior tranche may get the lower CRR capital requirement. Those who invest in synthetic securitisations – almost invariably in the mezzanine but also sometime at the first loss level - will get no formal regulatory benefit. But the rules do create a standard of transparency and robustness, just as they did for true sale securitisation. Even though the refusal to allow lower capital for non-senior bank investors is logically questionable, the simple creation of a legislative standard cannot but help attract more investors to this market. And this will help European finance.

Finally, European citizens benefit from a standard that, like the original true-sale STS standard, ensures that banks hold the proper capital for the risks they run. This will be part of the multiple rules designed to ensure that there will not be a repetition of the bail-out of the banking system in 2008-2009 and later which so damaged the European economic fabric.

How does the proposed STS synthetic standard work?
The current proposal is firmly anchored in the work completed by the European institutions to set up the existing true sale STS standard. The new synthetic STS standard incorporates pretty much all the requirements of the current true sale STS standard as to simplicity, transparency and standardization.

Then, additional requirements reflecting the specific synthetic aspects of these securitisations were added. For example, how to handle the excess spread discussed above or interim payments made after a borrower has defaulted but before their loan has been fully enforced. These are issues that simply do not arise in true sale securitisations but needed to be dealt with here.

Finally, the criteria contain a number of rules to ensure that the synthetic securitisation genuinely transfers the risks of the underlying loans to the mezzanine and first loss investors. PCS has argued over the years that this was not the place for such rules as STS was an investor standard and the regulators already have a separate set of rules (the significant risk transfer or SRT rules) to deal with these types of issues.

However, by making the regulatory benefits of the new STS standard only available to the originator, the EBA and the Commission have indicated that they see the primary purpose of this legislation as insuring that banks using synthetic securitisation to recycle capital do not retain more risk than acceptable. In that optic, these additional SRT rules embedded in the STS standard are logical.

Does the proposal do the job?
Broadly, the answer is yes.

The EBA and the Commission should be commended for having prepared a good proposal.

Some highly technical aspects could no doubt do with some fine tuning particularly around the use of collateral in what are known as “funded” transactions. Also, by focusing on the capital position of the originator rather that the position of the investor but using an investor standard as a starting point, the legislation does have what can appear at times an odd hybrid nature. But this does not harm the effectiveness of the whole even if it does, at times, lead to some unnecessary features.

What more needs to be done?
The synthetic STS standard is a welcome step forward. In the recent article cited earlier in this Q&A we joined the growing chorus of independent voices – including two high level committees set up by public bodies– in suggesting that the STS regime, for all its undoubted quality, was an unfinished project.

The key to unlocking the benefits of securitisation whilst maintaining the safety and integrity of the European financial framework is to look once more with an objective eye at the current capital requirements for high quality STS securitisation in the CRR and Solvency II as well as at the eligibility rules for inclusion in the Liquidity Cover Ratio (“LCR”) rules.

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5. Our people

PCS is a compact organisation with a total staff of 11. In each newsletter we will introduce one of them so that people get to know us. This time, Martina Spaeth, Member of the Analytical Team. The people in the Analytical Team are the direct contacts of issuers and their arrangers and lawyers in the process of verification. They are also available at any time to answer investors' or potential investors' questions about any PCS verified transaction.

Martina Spaeth

"When I joined Swiss Bank Corporation in 1997, which was my first banking job after acquiring a PhD in Chemistry at the Max Planck Institute, I got involved in preparing the first RMBS transaction inSwitzerland and only the second RMBS in the German speaking market, which came to the market in 1998. It must have been love at first sight, since I have not stopped working in securitisation since. Working for Fitch Ratings in London I remember having the very first discussions on German synthetics with KfW.

I have been Head of the German Securitisation team at HypoVereinsbank (now Unicredit) in Munich where I spent 10 years of my career. HypoVereinsbank at the time was the biggest issuer in the German market and a majority of the transactions we issued were actually synthetic. I was able to change perspective by being on the investor's side of securitisation at my previous position at FMS, the German state owned organisation responsible for winding down a very complex structured products portfolio, before I joined PCS in June 2019.

On a personal level, I am married and have a daughter and a son. My main hobby and passion is centred around playing classical music in orchestras and chamber groups. I love speaking foreign languages and actively ski, cycle and hike in the Austrian Alps."

Contact information

For any questions or comments on this STS Newsletter you can contact the PCS staff.

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