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Synthetic securitisation

Hong Kong

香港

合成證券化

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Legal Overview

Synthetic securitisation 合成證券化

On 30 June 2021, the Banking (Capital) (Amendment) Rules 2020 (L.N. 44 of 2020) will become effective in Hong Kong introducing, for the first time, a framework for banks in Hong Kong to enter synthetic securitisation transactions using special purpose entities (SPEs). This amendment brings the Hong Kong rules fully up-to-date with those in Europe and opens up the option for Banks in Hong Kong to use this powerful risk mitigation tool by entering into capital markets transactions with international institutional investors.

Synthetic securitisations are known by a variety of names – SRT, capital relief trades, balance sheet synthetics, “reg cap” trades and credit risk sharing deals. They’re all about a bank sharing the credit risk of a pool of assets with one or more investors.

Background

Synthetic securitisation transactions give banks a powerful tool which they can use as part of their balance sheet management strategy.

Banks must hold regulatory capital against all of their exposures – the amount of regulatory capital they hold is a reflection of the credit risk of the exposure, essentially the likelihood of the bank getting paid. For a loan advanced by a bank, the amount of regulatory capital the bank has to hold against that loan will be based on the credit risk of the borrower. Where collateral is provided in support of the loan (e.g., cash, or securities) the credit risk which the bank is exposed to can be mitigated and the bank will reduce the regulatory capital it holds accordingly. A guarantee could also be provided covering the loan and, if certain conditions are met and where the guarantor is less risky that the borrower, the bank can hold its regulatory capital based on the credit risk of the guarantor, rather than the borrower, mitigating the amount of regulatory capital it holds.

Synthetic securitisation takes this concept and then applies it on a much larger scale, in relation to a pool of loans, rather than just a single loan. Also, with a synthetic securitisation, the guarantee will not cover all of the risk of the loans in the pool, but typically the first losses in the pool, up to a specified amount. From the bank’s perspective, such a guarantee mitigates a significant amount of the credit risk in the pool and, provided the applicable regulatory rules are met, allows the bank to reduce the amount of regulatory capital it holds; the bank can hold less regulatory capital because the credit risk it had originally been exposed to has been transferred – the guarantor is now on the hook for a lot of the “credit risk” which is present in the pool of loans.

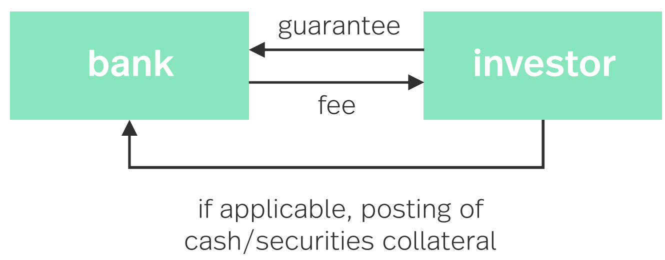
Basel III, implemented in Hong Kong under the Banking (Capital) Rules (Cap. 155L) sets out strict guidelines on the criteria which must be met to allow banks to undertake these transactions – only in instances where it have transferred a significant amount of credit risk to a third party guarantor will a bank be able to reduce the amount of regulatory capital it holds.

Guarantors: the investors

Aside from the bank, the other key participant in a synthetic securitisation transaction is the guarantor – commonly referred to as the investor. Sometimes, for large deals, there are more than one. When investors invest in these transactions they will be paid a fee for doing so – this fee is paid by the originator and is negotiated based on the precise level of risk which the investor will be agreeing to guarantee.

The guarantee will also set out, in a lot of detail, the instances in which the guarantor must make payments to the bank. For instance, when a loan in the pool defaults the guarantee will provide that a payment must be made to the bank.

classical synthetic securitisation



Unfunded and funded guarantees

Sometimes the guarantees can be “unfunded”, that is to say that the guarantor will pay money over to the bank only when a default actually occurs. From the bank’s perspective they will adjust the amount of regulatory capital they hold by reference to the credit risk of the guarantor. That is because they are exposed to the credit risk of the guarantor in these unfunded arrangements.

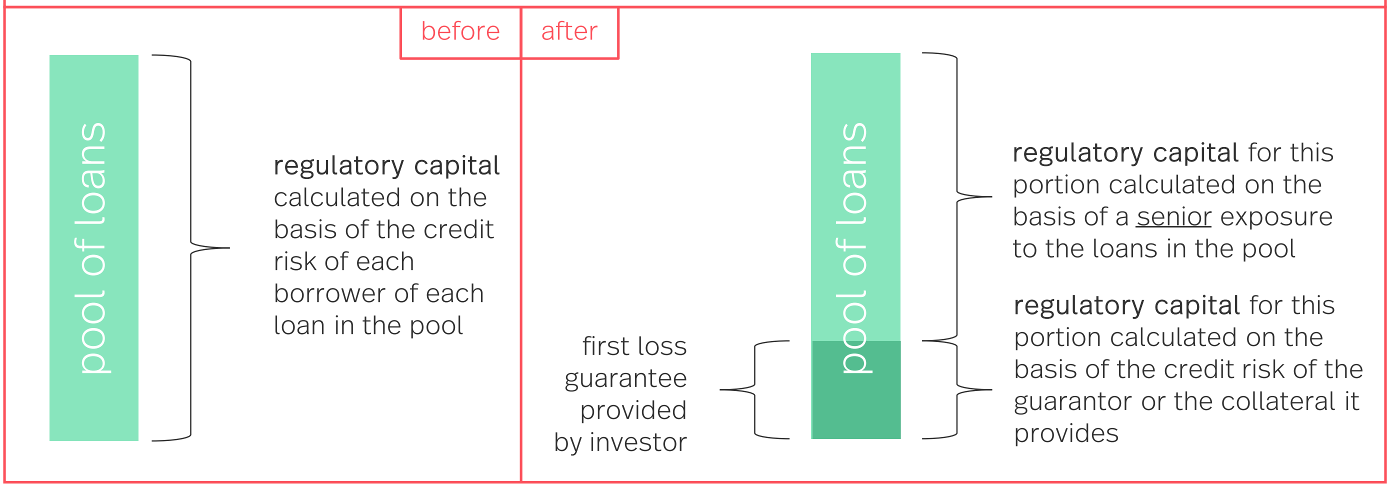
In other “funded” arrangements, the guarantor might post cash, or securities, as collateral with the bank. If a default occurs in the pool the bank will deduct the loss from the collateral and the guarantor will get less collateral back at the end of the arrangement.

Funded transactions

In the case of funded transactions, where collateral has been posted, the bank is not exposed to the guarantor's credit risk. It is exposed to the credit risk of the cash, or securities, it holds and the credit risk of cash, or securities, is often significantly less than the credit risk of the guarantor, allowing the bank to significantly reduce the amount of regulatory capital which it is required to hold.

However, with "funded" arrangements, the risk profile of the guarantor is quite different. It will have posted cash, or securities, as collateral with the bank and, if the bank becomes insolvent, the guarantor may not get the collateral back. This means that, <u>with funded arrangements</u>, which give the bank the best regulatory capital treatment, <u>the guarantor is exposed to bank credit risk</u>.

basis for regulatory capital requirement



SPEs – bridging the credit risk gap

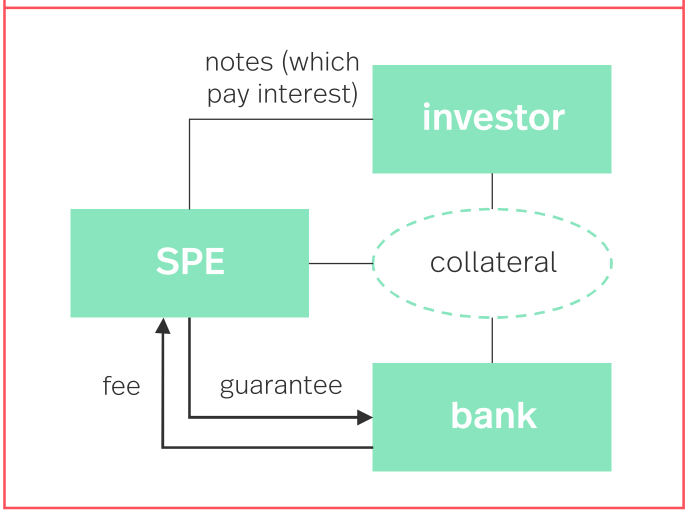
Due to the fact that the classical synthetic securitisation structures would involve one or other of the bank or the investor to accept exposure to the credit risk of the other, there was a degree of inefficiency. If the bank did not require the investor to post collateral then the regulatory capital benefit would not be as great and, on the other hand, if the investor did post collateral they would become exposed to bank credit risk and seek to charge a higher fee for participating.

It is for this reason that the SPE synthetic securitisation structures were developed in Europe and, over time, given specific regulatory acceptance. It is this structure that the Banking (Capital) (Amendment) Rules 2020 (L.N. 44 of 2020) implement in Hong Kong.

Generally speaking, an insolvency remote SPE will be established. Its insolvency remote nature is established using standard securitisation techniques of limited recourse, non-petition and negative covenants. There is no "credit risk", in any conventional sense, in an insolvency remote SPE.

The SPE is used to interface with the investor on the one hand and the bank on the other. Investors post collateral to the SPE. The collateral remains in the name of the SPE, usually held with a custodian. The collateral is made available to the bank, in the manner required under the regulatory capital rules, for it to take it into account when calculating its regulatory capital. But because the collateral continues to be held by the SPE, if the bank becomes insolvent, the collateral will not get "lost" in the insolvent estate of the bank. The collateral would be available to be passed to the investor as the transaction ends, as it may typically do upon a bank insolvency.

SPE synthetic securitisation



Technical Requirements

Section 230

In Hong Kong, the synthetic securitisation rules are set out in the Banking (Capital) Rules (Cap. 155L) (the "BCR"). The starting point for determining whether the technical requirements have been met in respect of a specific transaction is section 230.

Securitisation transaction

To qualify, the arrangement must been the definition of a "securitisation transaction" found in BCR section 227(1). Broadly speaking, the arrangement must involve a tranching of credit risk relating to an underlying pool of exposures, where payments to investors are dependent on the performance of the exposures and the subordination of the tranches determines the distribution of losses during the life of the transactions. A typical SPE synthetic securitisation would meet this requirement.

"Synthetic"

The next requirement is that the arrangement must be "synthetic", in the sense that it provides credit protection. For the purposes of the synthetic securitisation rules the applicable definition of "credit protection" is found in BCR section 51(1).

Recognised guarantee

To constitute eligible credit protection, the guarantee from the investor must be a "recognised guarantee". This is defined in BCR section 98 and the requirements should be checked against the guarantee which is drafted for the transaction. Note also that a "recognised credit derivative" meeting the criteria in BCR section 99 would also qualify.

The updates to the BCR which become effective on 30 June 2021 clarify that a SPE is capable of providing a "recognised guarantee" in the context of the synthetic securitisation rules.

Schedule 10 requirements

The requirements set out in BCR Schedule 10 must all be met – importantly, "significant risk transfer" – a significant proportion of the credit risk in the underlying exposures must be transferred to third party investors.

SPE requirements

Section 2(a) of BCR Schedule outlines some minimum requirements which the SPE in the securitisation transaction must meet. This includes the following criteria:

- the SPE assets fall with certain categories, such as cash and highly rated securities;
- no underlying assets can be "re-securitisation" exposures;
- the assets of the SPE should be available to make payments to the bank;
- no other claims (e.g., to the investors) can rank in priority to or equally with the payments to the bank; and
- the collateral arrangements governing the assets and payments to the bank must meet the "recognised collateral" requirements in BCR section 77.

The requirement for the arrangements to constitute 'recognised collateral" is also required by BCR section 243.

Calculation of regulatory capital

Assuming the technical requirements have been met, the bank can then calculate its regulatory capital in the manner set out in BCR section 230(2A)(b) such that it should decompose the underlying exposures into two sub-tranches:

- a senior un-protected tranche, in respect of which the bank should use SEC-SA, SEC-ERBA, SEC-IRBA or SEC-FBA to calculation its regulatory capital; and
- a junior protected tranche, in respect of which the bank should calculate its regulatory capital based on the credit risk of the assets held by the SPE – which would generally be the risk weight applicable to cash or highly rated securities.

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