Significant risk transfer (SRT) transactions enable credit institutions to achieve a reduction in the amount of regulatory capital they are required to hold by transferring the credit risk in respect of certain assets to other parties as part of either a traditional cash securitisation or a synthetic securitisation. Credit institutions hoping to engage in SRT transactions need to consider the relevant regulatory framework governing SRT transactions, which seeks to prevent regulatory arbitrage where there is a technical asset transfer but not a substantive transfer of risk commensurate with the regulatory capital saving proposed to be achieved by the securitisation.

**Why do an SRT transaction?**

Increased regulatory capital requirements and pressure to de-lever balance sheets have been key drivers of the SRT market. The principal purpose of an SRT transaction is to reduce a credit institution’s Risk Weighted Assets (RWA) either generally or in respect of one or more particular asset classes. SRT may:

- allow more efficient deployment of available capital by releasing capital held against existing business for deployment in other areas;
- de-risk an institution’s entry into new markets or products; and
- allow a lender to maintain a presence in capital intensive or less lucrative market sectors.

**How is an SRT transaction structured?**

An SRT transaction may be structured as a traditional cash securitisation or a synthetic securitisation. A synthetic securitisation for SRT purposes which is to be marketed to several investors often consist of (1) a credit default swap entered into between the credit institution and a special purpose vehicle and (2) credit linked notes (CLNs) issued by the SPV to investors. Following the occurrence of a credit event with respect to an obligation in the reference portfolio, a cash settlement amount is paid by the SPV to the credit institution pursuant to the CDS and the outstanding principal balance of the CLNs is written down by a corresponding amount. Such CLNs can be listed, rated and/or traded in the clearing systems, depending on investor requirements.

Synthetic securitisations comprising a credit default swap (CDS) and CLN are the focus of this note. However, traditional cash securitisations can also be SRT-compliant and SRT-compliant synthetic securitisations may also be structured as guarantees granted directly by investors to a credit institution, as a credit default swap entered into directly between an investor and a credit institution or as credit linked notes issued directly to investors.

**Who invests in SRT transactions?**

Typical investors in SRT transactions are sophisticated institutions, pension funds and hedge funds whose mandates require them to seek relatively high-yielding investments and who are able to invest in higher-risk investments such as credit linked notes which will be subject to principal write-down on the occurrence of a credit event.

**Key regulatory criteria**
An EEA credit institution entering into an SRT transaction will need to ensure that the transaction satisfies the SRT criteria set out in the Capital Requirements Regulation (CRR) and the related guidelines published by the European Banking Authority (the EBA Guidelines), which aim to promote the development of a level playing field for SRT across different member states. This regulatory framework is a balance between precise mechanistic rules and principles that are more open to interpretation.

Articles 243 and 244 CRR set out the principal regulatory requirements for SRT transactions (for traditional securitisation and synthetic securitisation respectively), including economic requirements to assess whether the risk transferred is significant and commensurate with the capital relief afforded.

The other main regulatory conditions for an SRT transaction structured as a synthetic securitisation are:

- the documentation must reflect the economic substance of the transaction. This must be considered by the credit institution as part of its approvals and governance processes;
- the CRR credit risk mitigation techniques must be complied with;
- the terms and conditions must not:
  - contain significant materiality thresholds below which credit protection is not triggered if a credit event occurs;
  - allow the credit protection to be terminated due to a deterioration in the credit quality of the reference portfolio;
  - other than in the case of early amortisation, require the originator to improve the positions in the securitisation; or
  - increase the yield payable to investors if the credit quality of the reference portfolio deteriorates;
- a legal opinion from qualified counsel as to the enforceability of the securitisation documentation is required;
- any purchase or repurchase of securitisation positions must be on arm’s length terms; and
- any clean-up call option must only be exercisable when 10% or less of the original value of the reference portfolio remains unamortised and must not be structured to avoid allocating losses to investors or to provide credit enhancement.

A credit institution will typically request that its legal advisers confirm the satisfaction of most of these criteria in an SRT memorandum.

Other CRR requirements will also be relevant to any SRT securitisation, including the risk retention requirements of Article 405, the credit granting criteria of Article 408 and the Article 248 requirement that the originator does not provide implicit support to the securitisation.

Engagement with the relevant competent authority will be required at an early stage to ensure satisfaction of the criteria. The focus will be on ensuring that there are no structural features which could undermine the claimed credit risk transfer to third parties. Particular concerns include:

- Investors: The investors must be independent third parties. This means that the institution must not provide significant financing to them and there must be no other connection.
between the investor and the institution which could lead to the termination of the credit protection. A minority shareholder may constitute an independent third party for these purposes if it clearly does not have any control rights which could be exercised to terminate the credit protection. An entity falling within the same prudential consolidation group as the originator is unlikely to constitute an independent third party.

- Replenishment mechanism: A reference portfolio may be replenished during the life of the transaction, but the objective of replenishment must not be to improve the quality of the portfolio in order to reduce the likelihood of investors suffering losses. Replenishment must not create maturity mismatches between the reference portfolio and the term of the credit protection.

- Call options: Regulatory and tax calls may be included where they are exercisable only by the originator as a result of changes to the legal or regulatory framework which impact the contractual relations between the parties or affect the economics of the transaction. There can be no investor put options.

**Key legal issues: insurance re-characterisation risk and tax**

In addition to compliance with the applicable regulatory criteria for achieving SRT treatment, a key legal issue for English law SRT transactions put in place by banks is ensuring that the transaction cannot be characterised as an insurance contract. This is important for a number of reasons, including that writing an insurance contract is usually a regulated activity, insurance premium tax is likely to be payable on premium payments made pursuant to an insurance contract and an insurance contract entails a duty of utmost good faith and can be avoided by the insurer if full disclosure is not made by the insured.

A number of precautions must be taken in order to mitigate the risk that a CDS could be re-characterised as an insurance contract, including:

- the CDS must provide for payment irrespective of whether or not the originator has actually suffered a loss; and
- the CDS must allow the originator some flexibility to dispose of the underlying exposures and it must not be a pre-requisite to payment under the CDS that the originator has an interest in the underlying exposures.

Market participants are generally comfortable that the risk of insurance re-characterisation can be addressed satisfactorily. This is, however, something that needs to be carefully considered on a case by case basis depending on the terms of each transaction.

Credit institutions will also want to ensure that their SRT trade achieves optimum treatment from a tax perspective so that payments in respect of the CLN and/or CDS are tax deductible. The tax analysis may depend on whether the SRT trade can properly be characterised as a derivative or not, which will depend on its terms, and it is worth noting that this analysis may differ from the accounting treatment of the SRT trade as a financial guarantee or otherwise.

**Key commercial issues**

Commercial discussions are likely to need to address the following questions:
• Availability of protection: how easily can protection claims be made by the originator and how quickly will protection payments be received?
• Independent verification: will an independent party verify that a credit event has occurred? If so, processes will need to be agreed up front to avoid subsequent challenge.
• Timing of protection payments: should protection payments be made only when the obligation has been fully worked out, or should interim protection payments be made with an interest-bearing true-up payment when the work out is complete?
• Servicing principles: by what standards will the reference portfolio be serviced?
• Investments: how will the proceeds of the CLN issuance be invested during the term of the transaction?
• Internal processes and governance: the institution will need appropriate, robust governance processes throughout the life of the transaction to ensure ongoing compliance with transaction terms and SRT criteria.
• Data protection: any applicable restrictions on disclosing information relating to reference obligations need to be identified and processes implemented.
• Systems, reporting: the institution must ensure that its systems and reporting structures are configured appropriately to identify verifiable credit events and to supply all reporting and other data required by investors and regulators.

If you have any questions about any of the matters raised in this briefing, please contact one of the below, or your usual Slaughter and May contact.

**Key practical considerations**

Institutions considering an SRT transaction for the first time will need to consider the following practicalities:

• Adviser engagement: appointing advisers at an early stage of the transaction will be essential. Legal advisers, the verification agent and the structuring advisers will all need to engage closely with various individuals in the originator.
• Due diligence: investors will usually expect to carry out detailed due diligence on the initial reference portfolio, especially where it consists of a small number of large exposures. This can be a time-consuming process for large or diverse portfolios.
Our recent experience of SRT transactions includes:

**Bank side experience**

We have acted for:

- a major European financial institution on a credit linked note issuance by in respect of a pool of auto loans and leases;

- a major European financial institution in respect of a significant risk transfer transaction structured as a funded credit default swap, to be entered into by the institution with an SPV entity and funded by an underwritten issuance of credit linked notes by the SPV. The transaction relates to a significant portfolio of reference obligations in the form of loans and other instruments originated in various different jurisdictions and has a number of innovative features; and

- Nordea Bank AB on the provision of credit protection (in relation to a large mortgage loan portfolio) to the purchaser of Nordea’s subsidiary bank in Poland.

**Investor side experience**

We have acted for a number of longstanding investor clients in respect of their investments in significant risk transfer transactions arranged by various financial institutions and using various different structures. Some examples are set out below.

- **Funded credit default swap structures;** where the relevant financial institution (as protection buyer) has entered into a funded credit default swap with an SPV entity (as protection seller) and where our client has invested in credit linked notes issued by that SPV:
  - a €121 million transaction arranged by CaixaBank, S.A.
  - a US$165 million transaction arranged by Standard Chartered
  - a €255 million transaction arranged by a major European financial institution
  - a €84 million transaction arranged by a major European financial institution
  - a €39 million transaction arranged by Banesto

- **Financial guarantee structures;** where the relevant financial institution (as beneficiary) has entered into a funded financial guarantee with an SPV entity (as guarantor) and the SPV has issued credit linked notes to fund its obligations under the guarantee:
  - a €77 million transaction arranged by Raiffeisenbank, where our client invested in the credit linked notes issued by the SPV
  - we advised a holder of credit linked notes issued using a financial guarantee structure in 2012 in connection with a potential dispute with the arranging bank in its capacity as servicer of the reference portfolio.
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