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Synthetic securitisation in the Philippines

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The Securitisation Act of the Philippines is concerned with traditional securitisation involving the issuance of asset-backed securities by a special purpose entity. The act does not deal with synthetic securitisation, defined in the Risk-based Capital Adequacy Framework for the Philippine Banking System as a transaction structure whereby "credit risk of an underlying pool of exposures is transferred, in whole or in part, through the use of funded (e.g., credit-linked notes) or unfunded (e.g., credit default swaps) credit derivatives or guarantees that serve to hedge the credit risk of the portfolio". As synthetic securitisation comes in various structures, the discussion below is limited to those specified in the above definition.

Credit-linked notes

In a simplified credit-linked note (CLN) structure, a bank issues a note linked to a financial asset in its portfolio (the 'reference asset'). The structure is funded because the bank receives the face value or principal of the note from the investor or note holder. The repayment by the bank of the principal to the note holder is contingent upon the non-occurrence of a defined credit event in relation to the obligor of the reference asset (eg, insolvency or failure to pay). In return, the note holder receives an economic return (via interest) reflecting the underlying credit risk of the reference asset. If the credit event does not occur, the note holder is paid the principal at par on the maturity date of the CLN. If a credit event occurs, a settlement amount, which may be considerably less than the principal, is paid to the note holder. Alternatively, a physical settlement (involving the delivery of the reference asset to the note holder) may be agreed upon by the parties. Effectively, therefore, the bank can transfer the credit risk of the reference asset to the note holder if a credit event occurs. In sum, the bank acquires credit protection from the note holder. Figure 1 encapsulates the structure.

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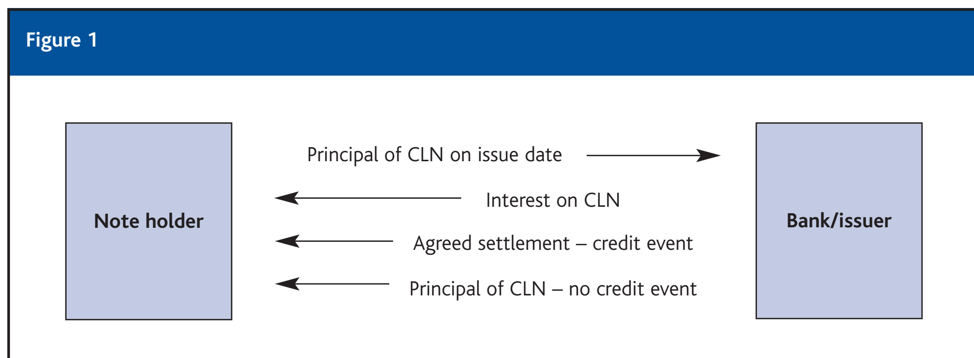
Figure 1



Credit default swap

As a credit default swap (CDS) is an unfunded structure, the Philippine bank does not issue a note to the credit protection provider. Here, the bank acquires the right to dispose of the reference asset or the right to receive payment from its counterparty, upon the occurrence of specified credit events. As shown in Figure 2, the bank (as the protected party) pays premium to its counterparty (as the protection provider), which makes no payments to the bank prior to the occurrence of a credit event. If a credit event occurs, the bank may be entitled to put the reference asset to its counterparty at a strike price fixed in advance or to demand cash payment from the counterparty. The cash amount will be fixed in advance and the residual value of the reference asset may be deducted therefrom.

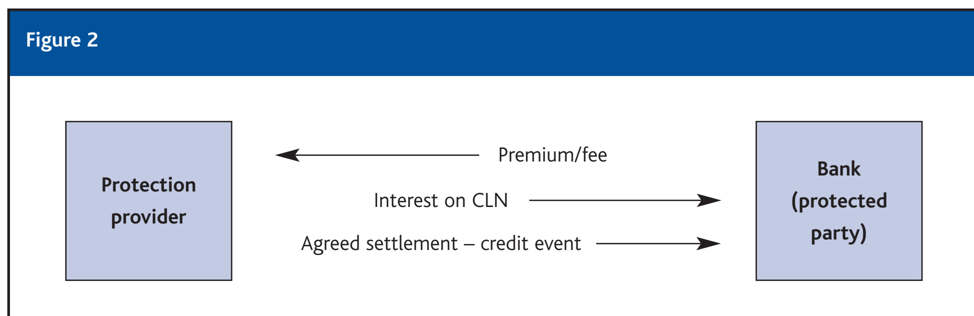
Central bank approval

The transfer of risk by a Philippine bank, through the use of credit derivatives (eg, a CLN or CDS), requires the prior approval of the Bangko Sentral ng Pilipinas, the Philippine central bank, so that the financial asset in question (as a loan or credit accommodation) will not be included in the computation of the single borrower's limit of such bank (Subsection X303.3, Manual of Regulations for Banks, as amended by Bangko Sentral ng Pilipinas Circular 425).

Credit risk mitigation: conditions

Moreover, the use of CLNs, CDS and other credit derivatives as credit risk mitigation techniques in synthetic securitisation will be recognised for risk-based capital purposes of Philippine banks only if certain conditions are satisfied. For instance, the bank must be able to transfer to third parties significant credit risk associated with the underlying exposure. Further, the transfer documentation must not contain terms or conditions that limit the amount of credit risk transferred, such as clauses that:

Figure 2



- materially limit the credit protection or credit risk transference;
- require the bank to alter the underlying exposure to improve the credit quality of the reference asset;
- increase the bank's cost of credit protection in response to the deterioration of the quality of the reference asset; or
- increase the yield payable to parties other than the bank (eg, investors or any third-party provider of credit enhancement) in response to a deterioration in the credit quality of the reference asset.

In addition, an opinion must be obtained from a qualified legal counsel confirming the enforceability of the contracts in all relevant jurisdictions.

Bank as protection seller

In the foregoing discussion, a Philippine bank acquires credit protection from third parties. In cases where the bank is the protection provider or seller, there is a need for it to obtain the requisite derivative licence from Bangko Sentral ng Pilipinas. In this regard, only universal banks and commercial banks are eligible to apply to the central bank for a type 1 expanded dealer authority, which enables the licensee to transact in all financial derivatives as a dealer, a broker or an end user. Without this type 1 licence, a universal bank or a commercial bank can invest only in "plain vanilla single-name CLNs where the reference asset is an obligation issued or guaranteed by Republic of the Philippines" (Bangko Sentral ng Pilipinas Circular 594).

Conclusion

Along with traditional securitisation structures under the Securitisation Act of the Philippines, synthetic securitisation under the Bangko Sentral ng Pilipinas capital adequacy rules (based on Basel II) presents business opportunities to providers and recipients of credit risk protection in today's age of derivatives. As a Philippine bank can act on either side of the transaction, the Bangko Sentral ng Pilipinas exercises its oversight function to keep these types of activity within the bounds of safe and sound banking practices.