SYNTHETIC SECURITISATION AND ITS VARIOS MANIFESTATIONS

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Today no one is surprised by the words “traditional securitization”. In the article an author considers one type of securitization, synthetic one. Without dwelling on the basic structures and concepts, the article describes the most interesting structure of synthetic securitization.

Synthetic securitisation

Financial Markets in its diversity is manifested by various structural transactions. Today no one is surprised by the words “traditional securitization”. In my article I would like to consider another type of securitization, synthetic one. Without dwelling on the basic structures and concepts, the article describes the most interesting structure of synthetic securitization.

The concept of “securitization” is interpreted by many authors individually, but keeping the basic essence of the definition. Given the major aspects of interpretations of the concept, we can conclude that the “securitization” is the process of structuring the securities traded among investors of different categories, secured by cash flows arising from current or future liabilities and letting to attract financing and / or credit risk reduction.

Synthetic securitization is the process of artificial securitization of the pool of debt obligations, without transferring underlying credits from the balance. Synthetic Securitization combines the advantages of both credit derivatives and traditional securitization. Synthetic securitization overcomes the shortcomings of the traditional structure of the transaction by combining credit derivatives with a synthetic structure. This means that the originator retains a pool of securitized assets on its balance sheets and transfer credit risk to investors, using the structure of traditional securitization. For banks that monitor the level of regulatory capital and applying risk-management, but not real interested in selling assets from its balance sheet, synthetic structure can be of great interest. It is difficult to identify a unified structure of the synthetic securitization deals. Some synthetic structures can use the SPV, some - do not use. In this article I would like to pay attention to the most interesting structures of the transaction.

In practice, many structures use a combination of CLN and CDS, but do not use specially created entity. The bank issuing bonds (notes) and the originator of the transaction are one and the same person. In other words, the functions of the originator are reflected in the active part of the Bank’s balance sheet, and the functions of notes issuance - in the passive. Originator brings together a pool of assets, which are then synthetically securitize partly by issuance of CLN. There is a credit link between reference portfolio and CLN. To transfer the residual credit risk of the reference portfolio, the issuer buys CDS protection. As a result, the entire amount of credit risk is transferred to the capital market by the mean of CLN and CDS. However, only CLN are funded instrument of securitization. Figure 1 shows the structure of a synthetic securitization without the use of SPV.

In practice, there are different variations of structures of synthetic transactions. Let us turn our attention to other aspects of synthetic structures.

Static and managed synthetic securitization

In the case of the static structure of the transaction reference (basic) portfolio is selected at the initial stage of the transaction and not subject to change over the life of the transaction. All parties to the transaction are aware of the specific commitments included in the base portfolio. Risk of replacement of one underlying obligation of the portfolio by another with less quality from a credit standpoint, equals to zero.

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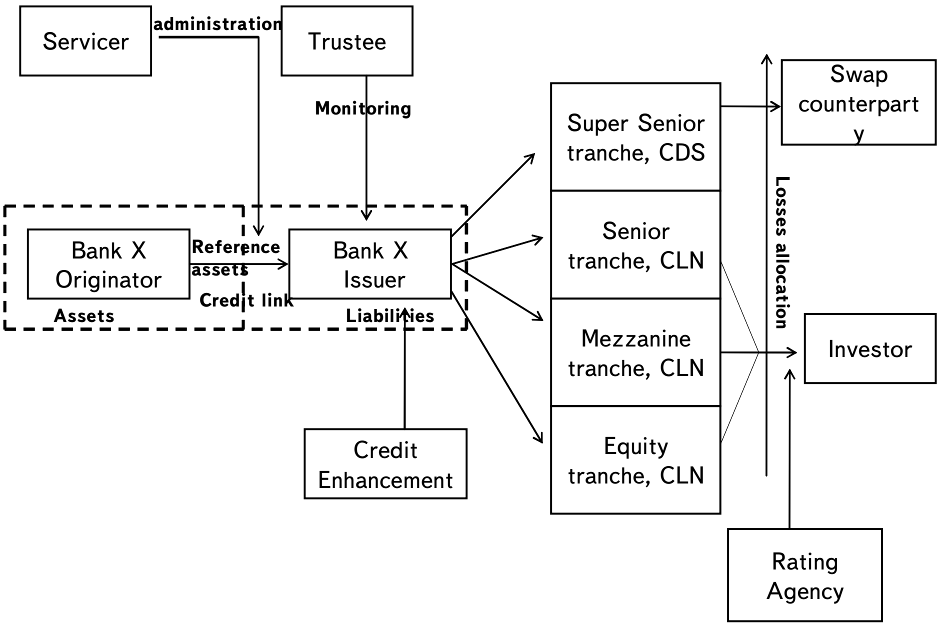

Fig. 1. **Structure of synthetic deal without SPV**

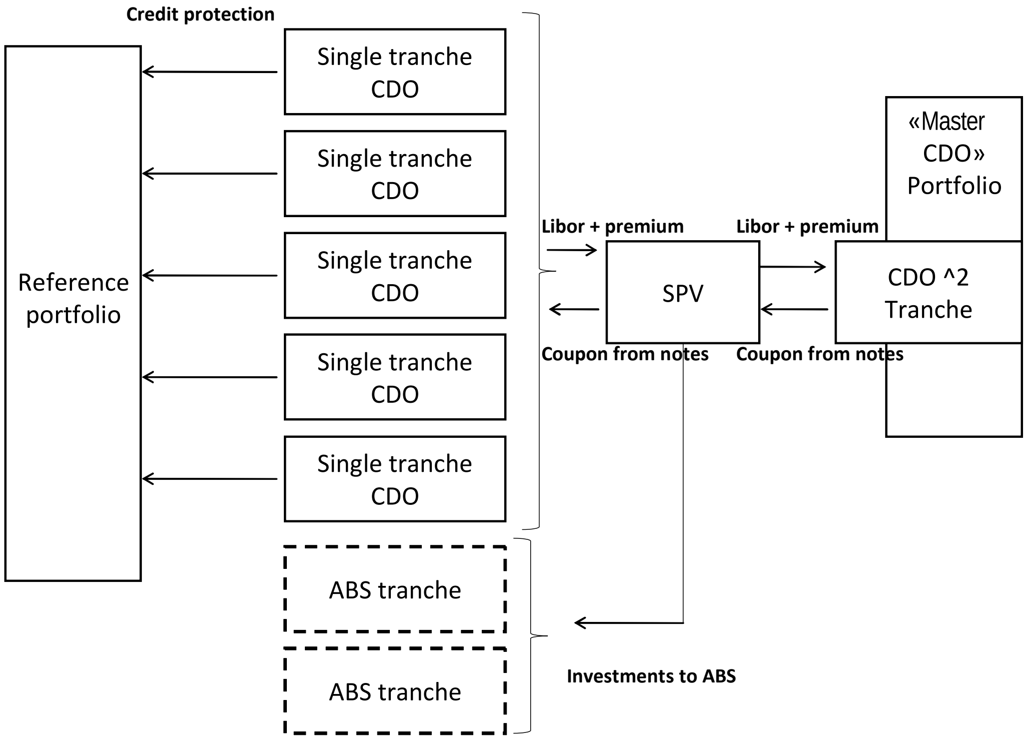

Fig. 2. **Structure of synthetic «CDO squared»**

In a managed structure of synthetic securitization changes to the core portfolio, can be implemented both by third-party managers and investor or dealer who arranged the transaction under consideration. The transaction can take advantage of the possibility of replacing credit exposures to maintaining or improving the risk profile of basic portfolio.

Synthetic resecuritization

Another structure of the transaction, it is worth paying attention to is the structure of synthetic resecuritization. Synthetic resecuritization, also known as synthetic structured finance CDO transaction, is a CDO, which is synthetically securitize a pool of already structured (securitized) assets such as commercial

MBS or other types of ABS. Synthetic resecuritization is similar to synthetic securitization that it provides investors with a protection of reference portfolio by the mean of a single portfolio credit-default swap or some single-name credit-default swaps. While the synthetic structure of the transaction transfers risk of corporate borrowers (names), synthetic resecuritization directly linked to specific tranches of notes in a structured finance transaction. Synthetic resecuritization can be static or managed, funded or unfunded, with one tranche or many tranches. Two features are inherent in this type of structure - definition of credit events and the mechanism of settlement of the transaction.

Synthetic CDO of CDO (CDO squared)

Synthetic CDO transaction, which has a reference portfolio consisting of tranches of CDO, is the latest innovation in the market of synthetic securitization and is called a synthetic CDO of CDO or «CDO squared». The assets underlying the synthetic «CDO squared» may constitute a synthetic CDO, and other ABS.

There are two levels of CDO in the structure of synthetic «CDO squared». A typical «CDO squared» transaction is based on the portfolio, called "Master CDO" and composed of other synthetic CDO tranches (inner CDO). Each inner CDO is single-tranche synthetic CDO, based on corporate obligations and structured in order of subordination, according to the rating of the tranche. In most «CDO squared» synthetic transactions, CDO tranches that make up the reference portfolio, are specially created for the purpose of inclusion in the structure of the transaction. Because of its synthetic nature, these CDO are conceptual and used to calculate cash flow and value of «CDO squared». The very same structure of «CDO squared» may be regarded as a complex derivative instrument. «Master CDO» portfolio can also benefit from subordination and can be sold to investors in one tranche.

Credit Linked Note - A security with an embedded credit default swap allowing the issuer to transfer a specific credit risk to credit investors.

Credit Default swap - is a swap contract in which the protection buyer of the CDS makes a series of payments to the protection seller and, in exchange, receives a payoff if a credit instrument (typically a bond or loan) experiences a credit event.

Mortgage backed security - is an asset-backed security or debt obligation that represents a claim on the cash flows from mortgage loans through a process known as securitization.

Asset backed security - is a security whose value and income payments are derived from and collateralized (or "backed") by a specified pool of underlying assets.

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