Fair winds

CRT issuance volumes broke all-time records last year and the pipeline continues to build. The only potential blots on the horizon are the regulatory pause in the US and the fallout from the collapse of Credit Suisse and Silicon Valley Bank, as **Stelios Papadopoulos** reports.

Capital relief trade issuance broke all-time records last year with the execution of 87 transactions overall, including from new jurisdictions and issuers such as Poland and the German Landesbanks respectively. However, the collapse of Silicon Valley Bank and the subsequent instability that has ensued raises questions about issuance this year – although the pipeline continues to build, as CRTs benefit from several advantages, including the lack of better alternatives for banks seeking to manage their capital.

According to SCI data, the number of transactions issued in 2022 reached 87 in total, representing an all-time record. Calculating tranche notional size remains challenging, given the opacity of the CRT market. But investor estimates for last year cohere around a €17bn- €20bn range, which would again be an all-time record.

Robert Bradbury, head of structured credit execution at Alvarez & Marsal, states: "Issuance picked up – at least in part – due to dramatic changes in the base rate that impacted the implied values of lower yield, legacy fixed rate books, as well as costs of funding. It was one of several drivers of SRT activity, since banks tried to optimise their holding of such affected books." ▶

Robert Bradbury, Alvarez & Marsal

Olivier Renault, head of risk sharing at Pemberton, comments: "Last year we saw 12 first-time issuers. The rise in issuance in 2022 was driven by a copycat effect, but also STS, which has proven to be a resounding success. STS allows many more banks to achieve efficient economics for SRT."

While the US market paused last year, North America has seen plenty of activity overall, as evidenced by BMO's record issuance. "It is paradoxical that US regulators have paused the market, given that US transactions are very clean, all first loss and with no complex features, while all are structured as direct CLNs. From a regulatory standpoint, there's no better structure, with banks having cash for the duration of the deal," observes Renault.

He continues: "Spreads, however, are now wider: when you add spread over Euribor or Libor, it's 3%-4%. Raising equity though is still expensive and CRTs make sense in that respect. Moreover, you can customise deals, so spread widening isn't that bad."

Similarly, Christophe Fritsch, global head of alternative credit at AXA IM, notes: "2022 has been one of the top years in terms of issuance, with €12bn – and the market continues to grow, with the number of banks involved increasing, despite the lack of issuance from US banks in 2022. German Landesbanks and those from Eastern Europe, for example, have executed their first SRT transactions last year. The type of underlying assets was similar to last year, with the exception in the rise of leveraged loan CRT issuance."

He continues: "Spreads have not dramatically widened – as with some other liquid credit alternatives – and transactions have been broadly enhanced, due to structural adjustments, such as shorter deals, tighter covenants and portfolio selection criteria. Nevertheless, the current economic environment with inflation, interest rate hikes and energy prices in some regions will remain a key area of focus for investors."

Additionally, Kaelyn Abrell, partner and portfolio manager at Arrowmark Partners, suggests that exposure to China was a risk, as well as consumer-based transactions. "Companies with revenues tied to consumers were also considered riskier. German SME transactions were one area that the market didn't differentiate on pricing. The trades priced similar to other geographies, despite the uncertainty related to the impact from the Ukraine conflict," she says.

Olivier Renault, Pemberton

Such risks haven't stopped investors from looking at blind portfolios, however. Tanmaya Sanghvi, head of independent valuations at Oxane Partners, explains: "Most of the inquiries from our side have, in fact, been about blind pools. Yet blind pools aren't exactly black boxes. Investors can get visibility on industry composition and internal ratings and thus the general risk profile."

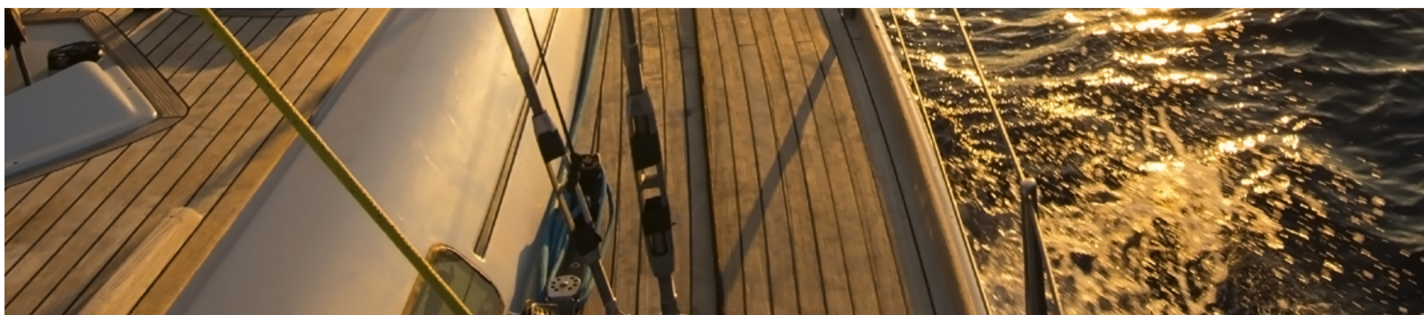
"2022 HAS BEEN ONE OF THE TOP YEARS IN TERMS OF ISSUANCE, WITH €12BN – AND THE MARKET CONTINUES TO GROW"

She continues: "But the traditional valuation methodologies aren't appropriate to value such trades, since there are changes that happen to the pool monthly, so we monitor the pool and adjust accordingly. Valuing the blind pool involves relying on internal ratings instead of an independent rating process."

Overall, bankruptcies rose by 20% quarter-on-quarter in 2H22, according to Luca Borella, co-founder at Algorthimica. Indeed, because of rising defaults, the issuer-weighted annual default rate for all Moody's-rated corporate issuers increased to 2.3% at the end of 2022, which is above the 0.8% rate in 2021. Nevertheless, this is still lower than the 3.2% rate in 2020, during the height of the Covid-19 pandemic.

Among speculative-grade issuers, the default rate showed a similar trend – rising to 4.3% at the end of 2022 from 1.8% in 2021, but down from 6.9% in 2020.

Defaults weren't the only risk emerging last year. The Basel output floor proved to be a major regulatory challenge, highlighted by the publication of



Kaelyn Abrell, Arrowmark Partners

a Risk Control report stating that the implementation of the floor risked rendering corporate and SME synthetic securitisation unviable *(SCI 22 November 2022)*. The only solution from the banks' perspective was to halve the p-factor.

The p-factor is an input into the SEC-SA and SEC-IRBA formulas, which were introduced well before the output floor was mooted. They govern non-neutrality for the retained senior tranches of synthetic securitisations, with the aim of addressing modelling and agency risks.

Under the output floor, a bank using internal models must now calculate RWAs using the standardised approach and then multiply the amount obtained by 72.5%. The output floor will be gradually introduced from 1 January 2025 over a period of five years. Effectively, this may lead to higher risk weights for the retained senior tranches of synthetic securitisations.

The p-factor gained attention with the introduction of the output floor, since the market has generally come to accept the output floor, despite its punitive impact on securitisation and SRT. As such, the focus shifted to the rectification of the SEC-SA through the halving of the p-factor. Several months of wrangling between regulators and the market followed, as the former proposed the reduction of the risk weight floor for the retained senior tranches of synthetic securitisations in lieu of halving the p-factor *(SCI 13 December 2022)*.

Nevertheless, both the European Parliament and the European Commission endorsed halving the p-factor, as momentum continues to grow in favour of the securitisation industry. The decision of the Trilogue meetings on this issue is still pending *(SCI 24 February)*.

Regulatory uncertainty was perhaps the dominant theme for the US market, as regulators paused it for various alleged reasons, including scepticism over the direct CLN structure. However, JPMorgan is said to be exploring SPV and other structures at the moment, so there may be light at the end of the tunnel *(SCI 9 February)*.

sheets that have to be managed along with higher capital requirements from stress tests and Basel 4. Still, this remains a big 'if', given current US regulatory attitudes towards CRTs.

Another question arising from the current bout of instability is what happens to the legacy CRT trades of Credit Suisse and the potential issues that this raises for CRT contracts going forward. The question that market participants are pondering doesn't concern credit events, with

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The collapse of Silicon Valley Bank and the financial instability that has ensued, along with the implications for CRT is currently in focus. At present, both the buy-side and the sell-side are continuing uninterruptedly with their trades, although some investors expect some spread widening to occur.

Nevertheless, arrangers and investors highlight several reasons why the current crisis is an opportunity for the CRT market. First, the challenges of the AT1 bond market – following the wipe-out of the Credit Suisse AT1 securities on the eve of the bank's acquisition by UBS – should be positive, since CRT has shown to be an alternative for banks seeking to manage their capital.

Second, whatever widening might occur, on a relative basis, deleveraging via synthetic hedges makes more sense than a costly and dilutive rights issue. Third, CRTs are private transactions, so deal premiums are largely non-directional since investors aren't taking any specific views on the market.

Fourth, across the Atlantic, the deposit outflows from the smaller US regional banks to the larger global US banks provides impetus for boosting CRT issuance, given the bigger balance

the Credit Suisse programmes – such as Elvetia – known for their stellar performance track record.

Instead, the bigger question is what UBS will do now, given that the bank virtually abandoned the CRT market as an issuer years ago. Its acquisition of Credit Suisse is still ongoing, so answers to such questions will take time to materialise.

Meanwhile, business continues as usual, with numerous trades in the pipeline. Looking ahead, Renault concludes: "This year we will see more opportunities to do deals with first-time issuers, continued growth and diversification and hopefully the resolution of the regulatory uncertainty in the US. Moreover, we are hoping that new ESMA templates for private deals will facilitate EU investors to participate in non-EU originated transactions, although that may only happen in 2024."

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