Securitisation innovation in focus

Winter 2019

CRT Research Report

Quarterly analysis for the risk transfer community

Standardised bank issuance | Transparency and liquidity | Market longevity | Data

SCI's 4th Annual Risk Transfer & Synthetics Seminar

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London, December 2019

Welcome to the first in a series of quarterly SCI Research Reports on the capital relief trades market. The reports aim to provide in-depth analyses of topical themes and trends being discussed in the sector, and are part of a premium subscription package offered to those involved in risk transfer.

This quarter, we examine standardised bank significant risk transfer activity. The report originally began as an investigation into ways of growing the CRT market more broadly, but it became clear that facilitating standardised bank access to risk transfer is especially important for the evolution of the sector.

Nearly €6trn in loans were treated under the standardised approach at end-2018 by European banks, the majority of which are small. Deleveraging and capital-raising are challenging for these financial institutions, leaving risk transfer as the most efficient tool for freeing up capital and maintaining a healthy solvency ratio.

Yet synthetic securitisation issuance by standardised banks remains constrained, despite favourable changes introduced under the new Securitisation Regulation at the beginning of 2019. This report explores the reasons why and puts forward some suggestions for improvement. It also outlines some of the processes and best practices that standardised banks should take into account when considering whether to execute an SRT deal.

But in order to level the playing field and help stimulate the real economy, other factors need to be addressed as well. Improving transparency, data, liquidity and standardisation are key.

Happy reading!

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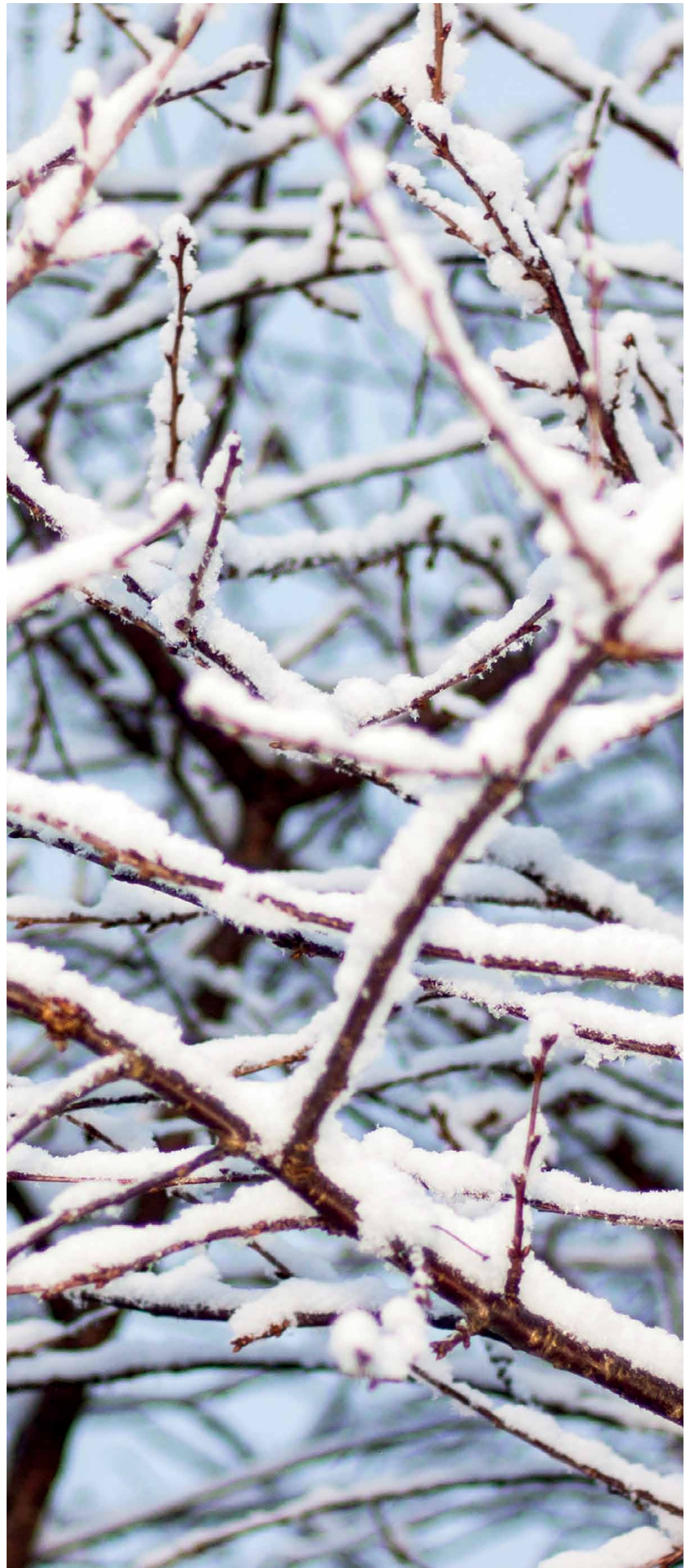


CHAPTER ONE: INTRODUCTION

European banks (excluding those in the UK) treated nearly €6trn in loans – €2.7trn to non-financial corporations, €1.9trn to retail customers and €1.3trn in mortgages – under the standardised approach to calculating risk-weighted assets at end-2018, according to ECB Statistical Data Warehouse figures. Deleveraging and raising capital are challenging for smaller European banks, leaving – in theory – risk transfer as the most efficient tool for freeing up capital and maintaining a healthy solvency ratio. Yet synthetic securitisation issuance by standardised banks remains constrained.

The vast majority of financial institutions in the EU are small and use the standardised approach under Basel 3. As such, Giuliano Giovannetti, md at Granular Investments, suggests that these banks suffer a double-whammy impact.

Double-whammy impact

"Capital is a real challenge for some small banks. They are already at a disadvantage because they follow more conservative RWA rules for standardised banks, have a higher cost of funding and struggle to raise capital, so they end up paying more in capital charges," he explains.

He continues: "EU policymakers talk about creating a level playing field and a banking model that is close to the real economy. However, deleveraging is not attractive for either the bank or the real economy, and raising capital is very hard for most smaller European banks – leaving (synthetic) securitisation as the most efficient tool for freeing up capital and keeping a healthy solvency ratio."

> "DELEVERAGING IS NOT ATTRACTIVE FOR EITHER THE BANK OR THE REAL ECONOMY, AND RAISING CAPITAL IS VERY HARD FOR MOST SMALLER EUROPEAN BANKS"

Synthetic securitisation (without a guarantee) only became a viable option for standardised banks when more efficient formulae were implemented under the CRR by Regulation 2401/2017 from 1 January 2019. Under the previous regulatory framework, banks that were not authorised to employ the internal rating-based approach (SEC-IRBA) in risk-weighting securitisation positions in SRT transactions had to apply to unrated securitisation positions a weighted-average risk weight equal to the lower between the weighted-average risk weight that would be applied to the securitised exposures (multiplied by the relevant concentration ratio) and 1,250%.

Pursuant to the new securitisation framework, instead, banks that cannot apply the SEC-IRBA method can now risk-weight unrated securitisation positions according to the new standardised approach (SEC-SA) and, only if they do not know the delinquency status for more than 5% of the

ITALIAN RENAISSANCE

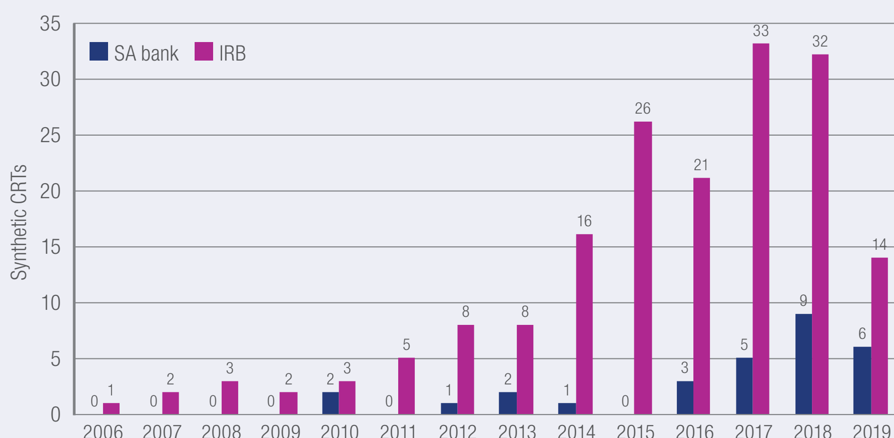
One jurisdiction where standardised bank SRT issuance is booming is Italy. The country exemplifies what can happen when a number of positive factors – pricing stability, new regulations that provide greater flexibility, supranationals keen to facilitate access for standardised banks and increasing investor interest – coalesce.

Banca IMI (Intesa Sanpaolo Group), for one, has closed 13 CRTs referencing circa €25bn of assets since 2014 (as of November 2019). The bank expects to execute another few deals by end-2019 and 1Q20.

Banca IMI broke new ground in July 2019 when it arranged the first two CRTs – referencing a €1.1bn SME portfolio and a €1.8bn residential mortgage portfolio – between an Italian standardised bank (Banca Popolare di Bari) and a private investor. Previously, Italian standardised banks had undertaken risk transfer transactions with the EIF, using its mezzanine guarantees.

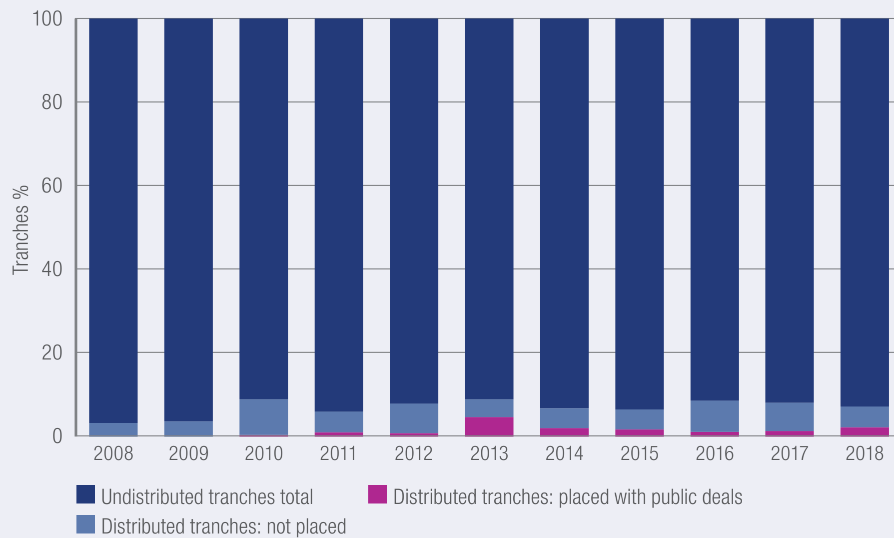
Among the Italian banks believed to be readying trades prior to year-end 2019 are Banca Popolare dell'Alto Adige, Monte dei Paschi di Siena and UBI Banca.

SA bank vs IRB synthetic CRTs to end-October 2019



Source: SCI capital relief trades deal database

Placed vs not placed part of the tranches of all transactions per year



Year/ distributed tranches (in € millions)	Undistributed tranches total size	Distributed tranches total size (not placed)	Distributed tranches (placed with public deals)	Distributed tranches placed with public deals (% of distributed tranches)	Distributed tranches placed with public deals (% of total size of the transactions)
Year 2008	64,925	2,229	0	0.0%	0.00%
Year 2009	34,632	1,340	0	0.0%	0.00%
Year 2010	14,148	1,314	78	5.6%	0.55%
Year 2011	24,923	1,328	276	17.2%	1.11%
Year 2012	22,562	1,732	221	11.3%	0.98%
Year 2013	17,228	802	894	52.7%	5.19%
Year 2014	32,031	1,639	702	30.0%	2.19%
Year 2015	65,601	3,382	1,226	26.6%	1.87%
Year 2016	45,442	3,727	5,868	13.6%	1.29%
Year 2017	48,738	3,647	700	16.1%	1.44%
Year 2018	96,975	5,137	2,417	32.0%	2.49%
Max value				52.7%	5.19%
Average				18.6%	1.55%

Source: IACPM

securitised exposures, the securitisation position must be risk-weighted at 1,250%.

"This has made it possible for smaller banks to contemplate synthetic securitisation, although we haven't seen them take it up yet in a meaningful way. A few examples are happening – such as Cajamar, Banca Popolare di Bari and Banco BPM deals that involved both private and supranational investors – but issues clearly remain around the complexity of risk transfer deals and the costs associated with them. Deals are still being underwritten by the EIF, which provides a full guarantee on a portfolio, to avoid the need to meet an SRT test," observes Giovannetti.

Gregorio Consoli, head of the banking and finance department at Chiomenti, believes that the revised hierarchy of approaches for the calculation of risk-weighted exposure amounts related to securitisation positions should encourage standardised banks to enter the SRT market. "The SEC-SA – introduced in order to reduce mechanistic reliance on external ratings and enhance risk sensitivity in risk-weighting non-IRB transactions – could enable standardised banks to apply to unrated securitisation positions risk-weights lower than those provided under the previous framework and more proportionate to the risk profile of the underlying exposures, thus fostering standardised bank interest in entering SRT transactions," he suggests.

Markus Schaber, Integer Advisors

Nevertheless, Integer Advisors managing partner Markus Schaber notes that the capital relief trades market remains somewhat constrained by the fact that it is dominated by a relatively small number of large IRB banks on the issuer side and by hedge funds on the investor side. He suggests that in order for the market to grow, a number of steps need to be taken.

Regulatory clarity

One crucial step is regulatory clarity in the sense of introducing a more prescriptive approach in terms of what an issuer can and can't do to achieve significant risk transfer. "Regulators generally won't provide ex ante guidance, which means it is not yet sufficiently straightforward to navigate the regulatory landscape. Execution risk can deter many banks from pursuing a CRT, as you need regulatory experience and infrastructure," Schaber observes.

He adds: "The de facto regulatory framework in practical terms remains the EBA's SRT discussion paper from 2017 for many structural features. Using this as a basis for clearer guidelines would allow for more efficient structuring and also reduce interpretation issues for the different teams at the regulator level."

Another step is to facilitate transparency by increasing the availability of performance data and pricing information. "It's difficult for a wider audience to get comfortable with the CRT market, given its relative opacity and lack of pricing comparables. As long as the market remains

GSE CREDIT RISK TRANSFER

The US credit risk transfer market – with its programmatic GSE issuance, bond market-style transparency and secondary liquidity – illustrates the upside that could accompany the liberalisation of the capital relief trades market in Europe. Fannie Mae and Freddie Mac have introduced a high level of standardisation and transparency across their CRT programmes, including data on price and credit performance.

The Fannie Mae CAS programme, for example, has seen cumulative issuance of US$40bn as of July 2019, according to Integer Advisors figures – with secondary trading volumes of around US$28bn over the last 12 months. Liquidity, in turn, anchors a deeper buyer base, while also facilitating repo activity and leverage-taking. As such, the US CRT programmes achieve significantly lower average protection costs relative to issuers in the European market.

Recent initiatives suggest that Fannie Mae is focused on increasing its programme appeal in Europe, stepping up its disclosure as a non-EU issuer in compliance with the new STS regulations covering EU investors.

> "THE DELTA IS SIGNIFICANT IN THE US CRT MARKET, WHICH IS PRIMARILY DRIVEN BY TRANSPARENCY, LIQUIDITY AND ACCESS TO LEVERAGE"

private, it's difficult to introduce bond market-style liquidity," Schaber notes.

He points to the US credit risk transfer market, where average spreads are much lower than those for European SRT deals (see box on GSE credit risk transfer). "The delta is significant in the US CRT market, which is primarily driven by transparency, liquidity and access to leverage."

Key disclosures

Key disclosures facilitating such transparency would comprise historical performance of portfolios and pricing information, including attachment and detachment points. However, Schaber suggests that should such clarity emerge, it is likely to still take a number of years – perhaps three to five – for the market to become significantly more standardised.

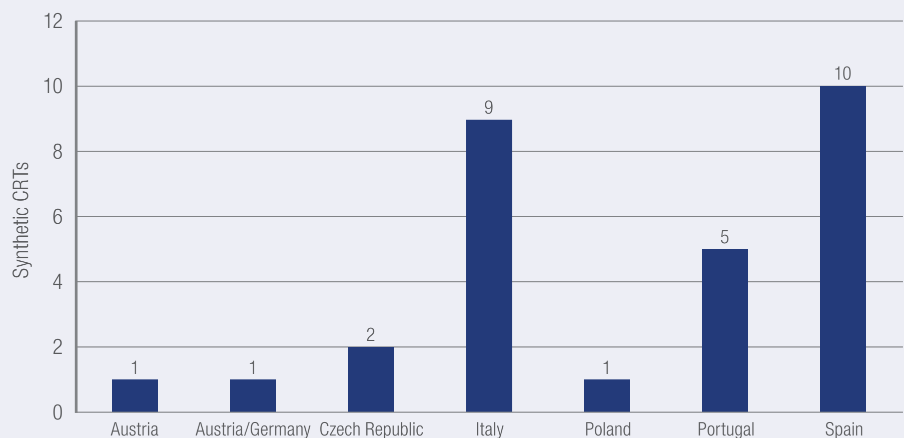
Although Kaikobad Kakalia, cio at Chorus Capital, anticipates issuance from standardised banks to grow over the next year or two, it will take time for this segment to gain traction and scale up. "It's not only regulation that restricts standardised banks' risk transfer activity, but also their own internal resourcing and capability. Crucially, they must have a sufficient quality and quantity of historic performance data to justify their risk metrics, which they typically lack."

The remainder of this report explores how access to the capital relief trades market can be improved for standardised banks and by extension drive further growth and innovation across the sector. The new regulatory framework, the role of the EIF and other mezzanine investors, transparency and liquidity will also be discussed. ■

CHAPTER TWO: STANDARDISED BANK ISSUANCE

Historically, SRT regulation has been better suited to IRB banks, as they could buy protection efficiently under the capital requirement rules. In contrast, before the new Securitisation Regulation was implemented in January 2019, standardised banks needed to buy protection on the entire capital structure – and the number of active investors that can provide senior coverage at economic rates is limited.

Georgi Stoev, who heads the securitisation business for central and northern Europe at the EIF, explains that as a countercyclical investor with a mandate to enhance access to finance for SMEs and develop financial markets across the EU, his institution believed that deals with standardised banks selling protection on the senior piece via financial guarantees could address this gap. Although it has engaged in many more since, the EIF's first SRT deal with a standardised bank was with Hypo Vorarlberg in December 2017.



Source: SCI capital relief trades deal database

RWA relief

The transaction featured mezzanine and senior guarantees on a €330m portfolio of mainly Austrian and German SMEs and mid-caps. The RWA relief achieved by the guarantees was close to €190m at closing.

Hypo Vorarlberg began looking more closely into SRT as an additional instrument for capital management at potentially attractive terms in early 2016. Florian Gorbach, head of treasury at the bank, says that given the positive experience of several IRB banks with EIF/EIB, it was natural to approach them at the very beginning of the project.

"In 2017 there was no efficient formula-based approach available for SA banks, such that the classic SRT 'blueprint' trade of IRB banks needed some adaption for our purposes. EIF guarantee terms proved to be an interesting alternative to getting the senior tranche rated," he explains.

David Blum, strategic bank management at Hypo Vorarlberg, adds: "Generally, we were very impressed by the level of professionalism both of EIF as an organisation, as well as the people involved in the transaction. Lacking a 'template trade' for a standardised bank, both EIF as well as EIB were willing to search for paths to successfully close the deal at several stages of the project. Also, as an inaugural transaction with only a few standardised banks having executed SRT trades, a supranational counterparty such as EIF increased both internal and external acceptance of the project."

The pair acknowledge that executing an SRT without a senior guarantee would have been even more challenging, as two more parties – rating agencies – would have been involved. Certainly timing, as well as potentially execution cost and efficiency would have been challenging.

The Hypo deal materialised within four months and banks in the same jurisdiction (Austria) are exploring similar trades, now that they know what is possible, according to Stoev. "Hypo Vorarlberg approached us after seeing us at conferences and in the press stating that we see merit in banks engaging in SRTs – although it took many such statements before we were heard."

He adds: "The fact that most SRT deals are private leads to a significant reduction in publicity, which means most standardised banks are in the dark about what can be done in terms of risk transfer. Publicity is key for the market to gain further momentum. It's not necessary to reveal every detail, but informing the market that a deal has happened would allow banks to understand what is plausible in a given jurisdiction and in a given asset class."

"THE FACT THAT MOST SRT DEALS ARE PRIVATE LEADS TO A SIGNIFICANT REDUCTION IN PUBLICITY, WHICH MEANS MOST STANDARDISED BANKS ARE IN THE DARK ABOUT WHAT CAN BE DONE IN TERMS OF RISK TRANSFER"

New regulation

The new Securitisation Regulation allows standardised banks to buy protection up to the mezzanine tranche – the 0%-15/16/17% piece rather than 0%-100%. In comparison, IRB banks achieve capital relief with 0%-7/8/9% protection, so standardised banks need investors to come in on top of a junior mezz investor for the 8%-16/17% piece. The EIF is active in this senior mezz segment and a number of insurers are also interested in the space, albeit on an unfunded basis (see chapter four).

Robert Bradbury, head of structuring and advisory at StormHarbour, suggests that recent transactions underline that there is now a smaller difference between how IRB and standardised banks are perceived by market participants. "The new securitisation regulations have helped level the playing field and created more options for standardised banks. Standardised banks now have more flexibility and potential transaction efficiency than was the case under the previous framework's ratings-based approach, for example, including with regards to retained senior tranche risk weights."

Gorbach agrees that the new securitisation framework levels the playing field between standardised and IRB banks, at least to some extent. "Today, there is additional flexibility for standardised banks, due to the availability of SEC-SA. As such, in our opinion, standardised banks could potentially become meaningful constituents of the SRT market – especially considering that under Basel 4, partial IRB use could soften the currently relatively clear borders between standardised and IRB banks."

However, he points out that new hurdles have arisen, following the introduction of the new securitisation regulations. For instance, standardised banks lack major scale effects in securitisation reporting requirements.

Recent SRT deals completed by EIF

Transaction	Signed Date	Amount (€)	On-lending to SMEs (€)
Ceska Sporitelna	Jun-19	75,000,000	300,000,000
Banco BPM	Jun-19	55,000,000	330,000,000
Unicredit Social Impact (EASI) 2	Jun-19	5,200,000	50,000,000
Santander Magdalena	Jun-19	50,000,000	200,000,000
Caixa	Mar-19	100,000,000	600,000,000
Large German Financial Intermediary	Dec-18	99,750,000	399,000,000
Banca Nazionale Del Lavoro Minerva	Dec-18	100,000,000	600,000,000
BBVA Vela 2018-2 Corporates Synthetic Securitisation	Dec-18	59,999,332	359,995,991
Cajamar	Dec-18	610,000,000	1,516,400,000
Alior Synthetic 2018-1	Dec-18	335,945,548	445,085,218
Polish Financial Intermediary	Dec-18	494,341,285	973,551,385

Source: European Investment Fund

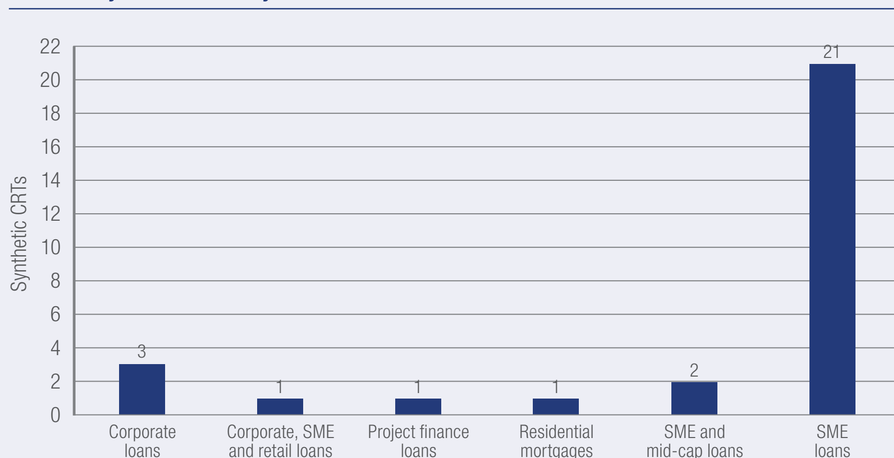
Nevertheless, should Hypo Vorarlberg be considering issuing another SRT deal in the future, the new framework theoretically enables it to issue without the EIF's involvement. In terms of assessing which portfolio would be the most economic to securitise – assuming the EIF isn't involved – Gorbach suggests that in order to achieve an efficient execution, it might "be advisable not to reinvent the wheel, but to stay somewhat close to what is observed in the market at the time".

CRR approaches

Steve Gandy, md and head of private debt mobilisation, notes and structuring at Santander Corporate and Investment Banking, notes that the decision-making and governance processes regarding whether to undertake an SRT transaction is the same for standardised and IRB banks – albeit they have to follow the specific rules under the different approaches of the CRR. The major variance is that IRB portfolios already have regulator approved models in place that allow the issuer to assign PDs and LGDs for each loan, which provides for an accurate assessment of expected loss and enables the bank to follow the SEC-IRBA formula. In contrast, standardised portfolios do not have models approved or individual PD and LGD calculations assigned; therefore, it is harder to estimate expected loss and hence they must use the SEC-ERBA or SEC-SA formula.

"The SA formula usually results in a bank needing to sell a thicker tranche because if they don't have an accurate assessment of expected loss, they need to build in a cushion for the regulator to get comfortable regarding the variability of losses," Gandy observes. "Capital relief is also subject to a haircut: the risk-weight floor is 15% for SEC-IRBA and 20% for standardised banks (although both enjoy a 10% floor if they are STS-compliant deals). The challenge is whether the thicker tranche and the haircut make economic sense from a cost-of-capital perspective."

Typically, the cost of capital is higher for banks that are smaller, less well-known or not active in capital markets and they may need to be prepared to provide a higher yield to investors, according to Gandy. He suggests that even if a bank may have to pay a higher yield, it may tolerate selling thicker tranches because it has a higher cost-of-capital hurdle rate.



Source: SCI capital relief trades deal database

THE NEW SECURITISATION REGULATION

From an economic perspective, the biggest impact of the new securitisation framework comes from the amendments to the EU Capital Requirements Regulation, which has introduced an across-the-board increase in the risk-weights applied to senior tranches. In response, capital relief trade issuers are thickening the tranches placed with investors and correspondingly reducing the size of the retained senior tranche.

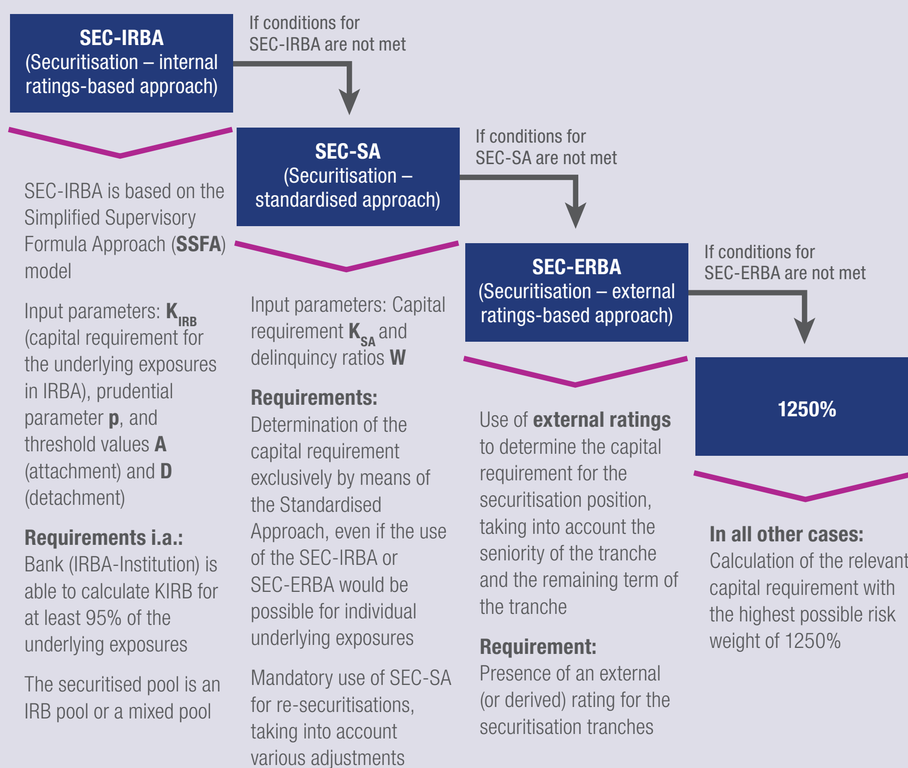
However, to make the associated increased cost of doing so more palatable, some originators have begun placing additional thin mezzanine tranches above the existing first loss or lower mezzanine tranche. As these additional/upper mezzanine tranches have a lower risk profile, they are attractive to different types of investors, including insurers.

Unlike traditional CRT investors, insurance firms benefit from high ratings and are therefore able to sell protection on an unfunded basis. Without the need to post collateral for the full notional amount of the protected tranche, such protection sellers are therefore able to accept a lower coupon.

The risk-weight hierarchies under the CRR have also changed under the new Securitisation Regulation. Under the old securitisation framework, the external ratings-based approach (ERBA) had precedence over the internal ratings-based (IRB) approach. Because the ERBA generally produced a higher risk-weight than the IRB approach, originators were disincentivised from soliciting a rating for tranches in a synthetic securitisation, as they would then need to use that rating for their capital calculations.

However, Clifford Chance notes that under the new securitisation framework, the internal ratings-based approach (SEC-IRBA) and the standardised approach (SEC-SA) generally take precedence over the ERBA (see 'Hierarchy of new calculation approaches' chart). As such,

Hierarchy of new calculation approaches



Source: Deloitte

an originator may solicit a rating for a placed tranche of a synthetic securitisation, without affecting its ability to use the generally more favourable SEC-IRBA methodology for its capital calculations – thereby opening up the placement of such tranches with investors who only invest in rated paper.

In the case of synthetic SME securitisations, Article 270 of the CRR permits originators to accord STS risk-weights to senior retained tranches. The vast majority of SME CRTs in recent years have involved EIF as the protection seller, implying that the active involvement of the fund is likely to be necessary for a significant number of transactions to take advantage of Article 270.

The SEC-IRBA and the SEC-SA are based on a supervisory formula to determine the risk weight for a securitisation position. The SEC-ERBA has recourse to risk weight tables, in which external credit assessments are assigned to corresponding risk weights, depending on the rank and maturity of a securitisation position.

Further, standardised banks may not have in-house CRR experts, which is an additional challenge in terms of assessing the viability of undertaking an SRT deal. Plus, the portfolios tend to have less information available about expected performance, which adds a conservatism factor to the analysis.

"Generally, it takes longer and needs greater effort to gather the necessary data for a standardised portfolio. It may not be in a digitised form, so it's a question of pulling up loan files and inputting historical loss and recovery information into a centralised system," says Gandy.

Appropriate portfolios

The next step is to decide on an appropriate portfolio to securitise, which is usually dictated by which portfolios a bank has adequate data for. Santander, for one, employs a matrix to assess the optimal portfolio to securitise.

Among the factors included in this matrix are: whether there is enough data to provide historical performance; is it a sufficiently large portfolio to justify the time and resources spent on a securitisation; are investors likely to be interested in the loan pool; is it highly concentrated or diversified; does the unit have prior securitisation experience (if so, their internal processes are developed and consequently an SRT is likely to involve less effort); are there any tax, local regulations or consent issues to consider; would a true sale or synthetic format make more sense; should a CLN or a financial guarantee be utilised; and does

the regulator accept unfunded deals or will cash collateral have to be posted? For smaller banks, a transaction involving a multilateral may be the best option, as part of their mandate is to bridge the gaps to capital market access of smaller banks.

"There are many different considerations when contemplating whether to execute an SRT," Gandy observes. "The key is to choose the most economically efficient portfolio and the rest is optimisation."

Blum agrees that an efficient SRT is easier to achieve the larger the available portfolio, the more resources are available and the better the available data is. In terms of identifying minimum requirements that a standardised bank needs in order to execute an SRT deal, he describes the process as more of a gradual trade-off against economic efficiency that the originator is able to achieve.

"For example, the lack of validated PD/LGD internal models is a trade-off against economic efficiency, as investors will price this in. On the other hand, PD/LGD modelling and validation appear to be becoming increasingly more in focus also for standardised banks, due to Pillar 2 or accounting standard requirements, such that one would expect investor confidence in standardised bank models to improve going forward," observes Blum.

Execution

In terms of execution, it can take between six to 12 months for a first-time issuer under the standardised approach, but three or four months – the same length of time as an IRB bank – for their next deal. Blum concurs that it would be much more straightforward to issue another SRT deal, having already executed one.

Although Gandy expects standardised bank issuance to continue growing, he notes that fear of the unknown and perceived structural complexities are hindering volumes. "It can be intimidating for smaller banks if they lack experience dealing with their regulator on the new STS regulation or on a less familiar area of the CRR. But regulators are generally becoming more aware of SRTs and they have access to the ECB's Joint Supervisory Team cross-sector group for advice on how to review deals. The more transactions hit the market, the more small banks will be encouraged to bring one themselves."

Gorbach concurs: "In order for standardised bank SRT issuance volumes to grow going forward, probably the most important driver is a few reference trades to close – which would spur confidence in the attractiveness, advantages and feasibility of SRT."

Riccardo Gallina, head of loan management and advisory at Banca IMI (Group Intesa Sanpaolo), agrees that there is potential for standardised banks to become meaningful constituents of the SRT market. "I anticipate that standardised bank SRT issuance volumes will continue to grow. Certainly, there is a lot of interest in this kind of tool among standardised banks," he says.

But he points out that the returns typically requested by traditional junior investors mean that transaction costs may be unaffordable for most standardised originators, given the conservative calibration of the SEC-SA approach requires standardised originators to protect a thicker first-loss tranche compared to IRB ones. "Consequently, we need to see investors accepting lower returns – as well as new categories of investors entering the market – and work on different tranching solutions or provide more comfort around the performance of the securitised portfolio. Since standardised banks don't have validated PD/LGD internal models, one way of doing this is to provide investors with solid historical performance data on the underlying portfolios."

A further way to grow standardised bank SRT volumes is to calibrate the current prudential framework to better reflect the risk profile of SRT securitisations, especially involving non-performing exposures, according to Gregorio Consoli, head of the banking and finance department at Chiomenti. "The new calculation approaches (including the SEC-SA) have been designed for performing portfolios and use a gross-book value (GBV) approach to capital calculation," he explains.

He continues: "The use of gross inputs is not consistent with the mechanics of NPE transactions, in which the transfer of the securitised exposures to the SPV at a discounted price writes off (all or at least part of) the expected losses in the portfolio and leave only a residual exposure substantially equal to the relevant net value. Against this background, as acknowledge by the EBA in its Opinion on the regulatory treatment of NPE securitisations of 23 October 2019, the application of the SEC-SA to NPE transactions produce much larger capital charges than the external rating approach (SEC-ERBA) and those charges are disproportionate to the actual risk embedded in the securitisation taking into account the protection provided by the NPEs' purchase price discount."

For this reason, the EBA has expressly invited the European Commission to reassess the current regulatory capital calibration for securitisations to address the technical shortcomings on NPE securitisations and, in particular, to review the inputs to the calculation approaches to better reflect the loss-absorbing effect of the purchase price discount in NPE transactions. "A change in the current regulatory framework in the direction recommended by the EBA would certainly promote the growth of the SRT market for standardised banks," Consoli notes.

> "IN ORDER FOR STANDARDISED BANK SRT ISSUANCE VOLUMES TO GROW GOING FORWARD, PROBABLY THE MOST IMPORTANT DRIVER IS A FEW REFERENCE TRADES TO CLOSE"

Best practices

In terms of best practices regarding standardised bank SRT deals, Banca IMI – acting as arranger/advisor – typically works on portfolio selection and different tranching solutions in order to optimise economics for the client and finding the most competitive investors, considering the risks to be covered. Gallina notes that the process involves the preparation of an exhaustive due diligence package that can give comfort to investors with regard to performance of the portfolios.

Similar to any IRB bank SRT deal, the due diligence package for a standardised bank transaction should include a pool-cut containing detailed information on the reference portfolio, historical data, extensive information on the organisation and the credit process.

According to Blum, the pros that a standardised bank should consider before executing an SRT deal include potentially attractive terms, an additional capital management tool and a steep learning curve for the organisation. The cons include the fact that it is a very challenging process for a first-timer, requires substantial resources and commitment across the bank and provides limited scalability for smaller banks. ■

CHAPTER THREE: TRANSPARENCY AND LIQUIDITY

Resources and execution risk are especially challenging for many standardised banks exploring whether to undertake a CRT transaction. If a level playing field for small and big banks is to be achieved, a way for the former to implement a transaction independently and with a high degree of certainty of regulatory approval is key.

Giuliano Giovannetti, md at Granular Investments, suggests that previous risk transfer deals could be used by smaller banks as templates, but not much information is publicly available. "For instance, it would be helpful if regulators could specify that if certain wording is used, they'll be comfortable with a given transaction. This would reduce the need to incur costs on documentation and legal fees, and provide assurance that the regulator will approve the transaction for SRT. Alternatively, an industry association could produce a template that would have a similar effect, but some sort of regulatory endorsement would still be needed."

Equally, there is room for the creation of a public body to provide comfort to regulators and political bodies that a deal has been properly scrutinised by a respected entity with no speculative goals and stimulate the growth of the risk transfer market, according to Giovannetti. He suggests that, given an adequate mandate and resources, the EIF – or another organisation – could act as a market-maker and distribute risk, citing KfW's pre-crisis activity as an example.

Data repository

Improved data would, in turn, facilitate a wider analysis of the market. Syril Pathmanathan, senior credit analyst at D.E. Shaw, believes that although some research groups are working on this, a more industry-led approach is needed.

"I think a central information repository would be helpful, particularly when a bilateral market – such as this one – limits data sharing and prevents rating agencies from collecting data," he observes. "There also aren't many third parties arranging deals in the market, which doesn't help, as every issuer develops its own data requirements. However, there will naturally be challenges, as some issuers have tight compliance requirements around sharing data."

Virgile Maixandeau, vp in the client financing and solutions group at Nomura, notes that availability of information is restricting the potential development of a secondary market for capital relief trades. "The imposition of overly restrictive NDAs means, more often than not, that the secondary buyer base for a given bond is more likely to be limited to an investor that already holds the bond or was involved in the primary process," he says.

He continues: "This is especially constraining when an investor is forced to only being able to enter into NDAs with the issuer themselves, rather than through back-to-backs, and hence is reliant on the issuer being open and willing to facilitate such investor and efficiently negotiate the NDA and provide other information in order for it to participate in the secondary market. However, sensitivity to share such portfolio information and the level of restrictions imposed (including, for instance, some issuers requiring notification and registration of bond transfers in order to gain access to reporting) varies greatly from bank to bank."

Giuliano Giovannetti, Granular Investments

"THERE ALSO AREN'T MANY THIRD PARTIES ARRANGING DEALS IN THE MARKET, WHICH DOESN'T HELP, AS EVERY ISSUER DEVELOPS ITS OWN DATA REQUIREMENTS"

Data on the SRT transactions notified to EBA (from July 2014)

	2014	2015	2016	2017	2018	1Q2019	Total
Number of transactions	**3**	**20**	**25**	**6**	**60**	**28**	**142**
Out of which synthetic	3	17	17	3	35	20	95
Out of which traditional	0	3	8	3	25	8	47
Total notional value (€ millions)	**3,328.50**	**41,363.60**	**31,326.80**	**5,400.80**	**90,028.30**	**27,446.30**	**198,894.30**
Out of which synthetic (€ millions)	3,328.50	36,579.10	24,485.00	1736.7	42,765.10	17,791.10	126,685.50
Out of which traditional (€ millions)		4,784.50	6,841.90	3,664	47,263.20	9,655.3	72,208.80

Source: European Banking Authority

Secondary activity

Kaikobad Kakalia, cio at Chorus Capital, agrees that there is room for CRT secondary activity to grow. "This lack of secondary activity is largely because most transactions are private, and placed with a small number of investors. These investors typically buy-and-hold their investments. Also, few banks are interested in market-making due to very high regulatory capital requirements on these tranches, and the lack of publicly available information due to the private nature of the market."

CRT secondary market activity is generally viewed as more of a tactical opportunity. Indeed, the last time the market saw meaningful secondary activity was when a large investor exited the strategy in 2016.

"Historically, some large credit investors have been in and out of the market, only playing opportunistically in the space when yields widen. This naturally gives more protective depth to a market where limited liquidity can be observed and we saw that in the rare instances where it was needed, such as when certain issuers ran into distress or specific investors sought to divest their portfolios as part of broader strategy shifts," Maixandeau observes.

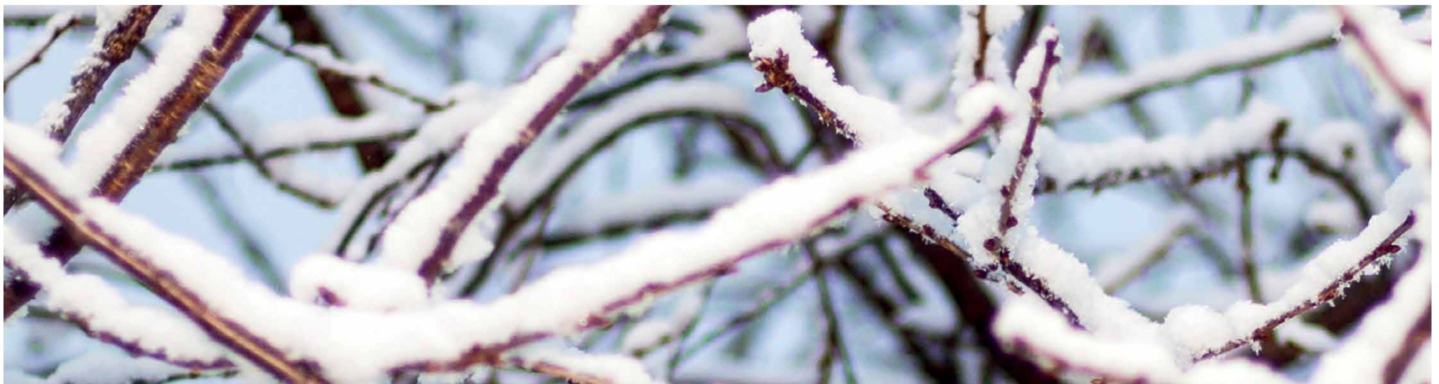
Nevertheless, Juan Grana, md at ArrowMark Partners, expects secondary activity to increase as the sector matures. But he notes that for trading to flourish, more syndicated and club deals are required, as well as greater dealer participation and a diverse group of investors with different investment objectives.

"While some investors see relative value between exposures and have different views on the market, what really seems to be driving secondary activity at the moment is sellers expressing concerns about specific geographies, specific names or different views on recoveries," he suggests.

Indeed, a credit downturn could spur secondary opportunities if some investors are forced to sell bonds or choose to reallocate to alternative sectors.

Ultimately, a capital provider outside of the banking system is required, according to Giovannetti. "Synthetic securitisation should transfer credit risk away from banks and to the private sector," he explains. "The GSE model in the US demonstrates that risk can be transferred from government institutions to private capital, including new sources such as re/insurers. There is clearly interest among insurers in taking this risk and if the EIF was involved as the fronting protection provider, insurers' protection would be even more efficient, as the EIF has a zero percent risk-weighting from the bank perspective." ■

"HISTORICALLY, SOME LARGE CREDIT INVESTORS HAVE BEEN IN AND OUT OF THE MARKET, ONLY PLAYING OPPORTUNISTICALLY IN THE SPACE WHEN YIELDS WIDEN"

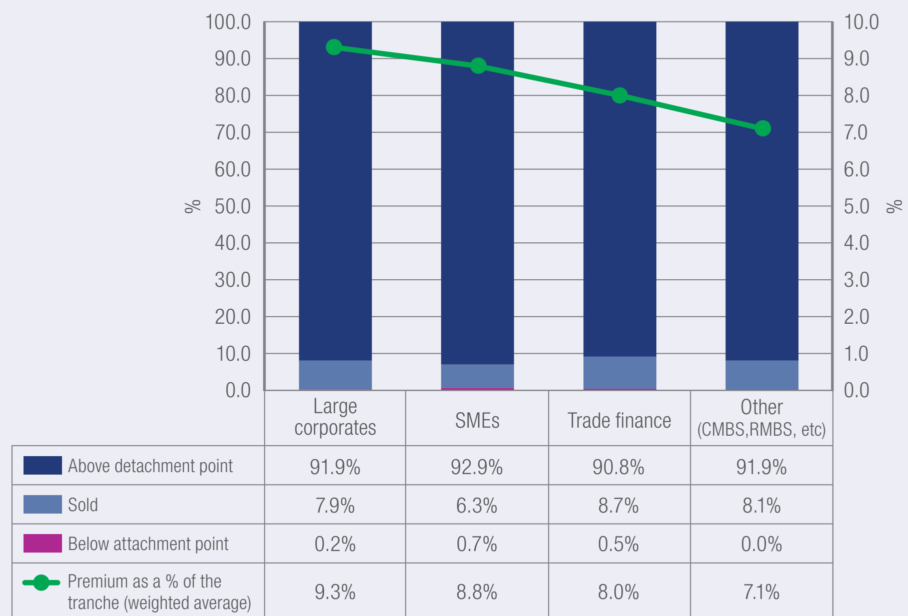


CHAPTER FOUR: MARKET LONGEVITY

In terms of bridging the gap between banks' needs and the availability of investor capital, the risk transfer market appears to be on the right trajectory. Indeed, the number of capital relief trade issuers is anticipated to double to around 80 and issuance double in volume within five years.

"There is plenty of interest from banks to issue and from investors to invest. Volumes will continue to rise, but the number of investors is unlikely to change meaningfully, as these trades are complicated and need a specific and specialised skill-set in order to properly understand the risk," indicates Kaikobad Kakalia, cio at Chorus Capital.

Attachment & detachment point of the risk sold of balance sheet securitisations in 2018



	Large corporates	SMEs	Trade finance	Other (CMBS,RMBS, etc)
Above detachment point	91.9%	92.9%	90.8%	91.9%
Sold	7.9%	6.3%	8.7%	8.1%
Below attachment point	0.2%	0.7%	0.5%	0.0%
Premium as a % of the tranche (weighted average)	9.3%	8.8%	8.0%	7.1%

Source: IACPM

Mezzanine risk

The pace of growth of the risk-sharing market is likely to be tied to the development of the synthetic mezzanine risk market, which is currently at a nascent stage. Traditional CRT investors have limited appetite for mezz, as absolute returns are low, even though the risk/reward proposition is compelling.

"There is an interesting opportunity to create and scale a new mezz investor base, by attracting asset managers and insurance companies that currently invest in ABS and CLO mezzanine tranches. A different type of capital – targeting 3%-4% returns, rather than 8%-10% – is required," Kakalia observes.

He continues: "The scale in this segment will most likely come from insurance companies. They are likely to find the risk/return interesting. However, most insurers will require ratings, and banks are yet to issue rated mezzanine tranches."

Robert Bradbury, head of structuring and advisory at StormHarbour, concurs that growing CRT mezzanine tranche volumes arising from dual-tranche structures may find demand from three types of investors: those seeking risk-adjusted returns (such as insurers); those with a mandate which includes bespoke transactions that offer relative value to comparable traded instruments (such as some CLO mezzanine investors); and/or those with very good access to leverage (such as real money investors that can borrow with cheap funding rates). While demand from the latter is less likely due to the lower expected returns from these tranches (and hence a smaller difference between the tranche return and the cost of the leverage), he agrees that the natural place for insurers to play in is mezzanine, as risk-adjusted returns are often more important to them than absolute returns.

But Bradbury indicates that a slew of mezzanine-only rated deals is unlikely; rather, they'll emerge on a case-by-case basis. "The overall analysis becomes more complex and expensive for publicly rated CRTs. Among several possibilities for transactions adding mezzanine protection to an existing structure (as opposed to incorporating the dual-tranche aspect from the outset), one possible approach may simply involve a standard structure and a mezzanine guarantee that incorporates the notes issued by the SPV," he says.

Georgi Stoev, who heads the securitisation business for central and northern Europe at the

"THERE IS AN INTERESTING OPPORTUNITY TO CREATE AND SCALE A NEW MEZZ INVESTOR BASE, BY ATTRACTING ASSET MANAGERS AND INSURANCE COMPANIES THAT CURRENTLY INVEST IN ABS AND CLO MEZZANINE TRANCHES"

STS SYNTHETICS FRAMEWORK

The extension of STS criteria to capital relief trades, as recommended by the EBA in a discussion paper from September 2019, could potentially be transformational for the sector in terms of unlocking mainstream investor liquidity. The paper proposes an STS framework for balance sheet synthetic deals that replicates the various criteria inherent in the STS framework for cash securitisations, while taking into account synthetic-specific features related to the credit protection arrangement, such as the inclusion of certain credit events and provisions for the calculation and timing of credit protection payments.

The proposed STS framework highlights two important structural aspects: STS synthetics would not be allowed to have bankruptcy of the protection buyer as a termination event, nor synthetic excess spread as a feature. Additionally, the EBA paper raises the possibility of a 'differentiated' framework, with potentially preferential terms for synthetic STS deals.

Overall, the paper suggests that an STS framework for synthetic securitisation would facilitate increased transparency, further standardisation and a potential positive impact on the capital markets and the real economy. However, it also notes that there is no equivalent framework for synthetic securitisation under the revised Basel securitisation framework.

Recent Integer Advisors research suggests that STS eligibility is at present arguably less relevant for CRTs, in that transactions are 'bottom-up' – whereby junior tranches are sold to investors and senior tranches are almost always retained (except for some standardised bank deals). Nevertheless, the firm stresses that STS eligibility would be a "powerful de facto endorsement" of the asset class, which should ultimately take the market out of the fringes by both de-stigmatising and standardising the product – in addition to potentially providing more favourable capital treatment most relevant for the retained senior tranche.

EIF, notes that attracting more senior mezz investors to the market is crucial for its development. Certainly from the EIF's perspective, its aim is to catalyse private money for the real economy; therefore, it's important for it to act alongside as many sophisticated investors as possible in risk transfer deals.

"We've seen increased interest from both newer and entrenched players to participate where EIF acts as anchor investor because of its ability to attract other investors. Many perceive our involvement in a deal as a stamp of quality," he observes.

As part of these efforts, the EIF is rolling out a new initiative that is complementary to the EIB counter-guarantee used in many of its previous SRT trades under the Junker plan with counter-guarantees from credit investors and insurers. Three such pilots are underway and the first one is expected to be finalised by end-2019.

Capital management

Looking ahead, the longevity of the risk-sharing market is driven by multiple factors, but influenced mostly by regulatory acceptance that risk-sharing is a suitable tool for bank capital management, a chronic lack of profitability within the banking system – driven by the low rates environment and lack of consolidation – and finally, further pressure on bank capital ratios driven by Basel 4. "Currently most banks undertake risk-sharing trades because they improve performance metrics," explains Kakalia. "The biggest issue in banking today is a lack of profitability. But risk-sharing also addresses concentration risk and it frees up credit lines, so banks can do more business with their core customers."

Indeed, Syril Pathmanathan, senior credit analyst at D.E. Shaw, points to the diversity in the transaction base. "A big driver of issuance is the situation that banks are facing," he observes.

Virgile Maixandeau, Nomura

"We had a summer where yields became increasingly negative in Europe, so earnings headwinds increased. This type of an environment makes capital management and risk transfer strategies highly relevant, as they can provide banks the oxygen to survive."

Virgile Maixandeau, vp in the client financing and solutions group at Nomura, believes that the market is poised to grow further. "Issuers entering the market typically (but not always) do so seeking to develop into programmatic issuances. The growth of this market has also been fuelled by an evolution in the perception of CRTs from being a post-crisis alleviator of capital pressures to a more institutionalised risk management tool, as well as providing limit relief and allowing banks to expand their lending in core asset classes. We believe that regulators are also recognising this; hence the push for continued harmonisation of structures and treatments across jurisdictions."

The EBA's STS synthetics consultation paper issued in September 2019 is seen as a positive sign in that it sets a clear precedent for a sound market and the authority endorses SRT in principal (see box on STS synthetics framework). "The paper suggests that the market is moving

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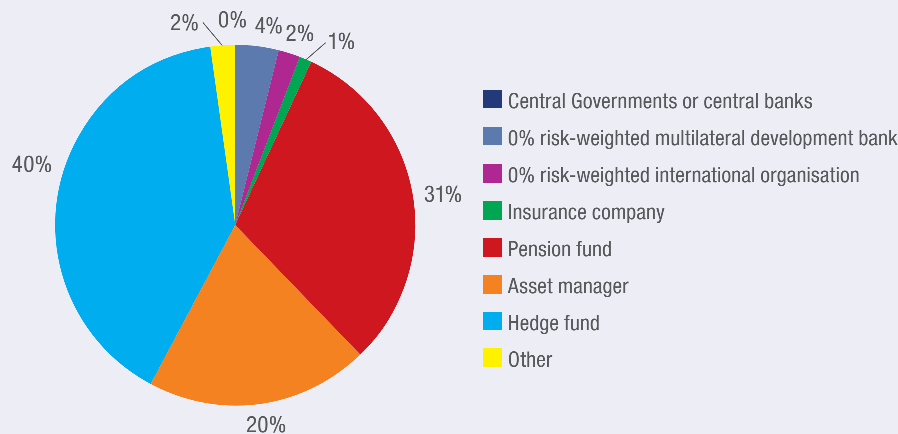
Investors, in terms of percent volume of distributed tranches over 2008-2019

Type of investor	2008-2017	2008-2019
Public investor: out of which	**1.1%**	**6.8%**
A. Central Governments or central banks	0.2%	0.2%
B. 0% risk-weighted multilateral development bank	0.6%	4.5%
C. 0% risk-weighted international organisation	0.3%	2.1%
Private investor (and no guarantee from A or B): out of which	**98.9%**	**92.9%**
D. Insurance company	0.2%	0.9%
E. Pension fund	40.1%	30.6%
F. Asset manager	15.1%	19.7%
G. Hedge fund	33.3%	39.6%
H. Other	2.8%	2.2%
Part of private investor which is funded	**89.7%**	**90.1%**



Source: IACPM

in the right direction and that regulatory clarity and standardisation will improve," says Markus Schaber, managing partner at Integer Advisors. "It facilitates the view that SRT is worth looking at and is not overly complex. And those CRTs that are ultimately awarded an STS label will provide common ground regarding structural features."

Basel 4

Further regulatory changes are still to be implemented under Basel 4, which kicks in in 2022 and will be rolled out over four years. "Banks will consequently need to manage capital floors that are likely to be impacted by their corporate and residential mortgage lending portfolios. Risk-sharing transactions address a number of strategic objectives, which suggests that the market is sustainable for at least the next 5-10 years and beyond," observes Kakalia.

Deals referencing high-LTV residential mortgage portfolios are already starting to emerge. Indeed, Lloyds – which was one early-mover with its Syon Securities 2019 transaction from July 2019 – is said to be motivated by creating a market dynamic for mortgage SRTs before it is compelled to issue.

Overall, Granular Investments md Giuliano Giovannetti believes that synthetic securitisation is underutilised, especially with Basel 4 looming on the horizon. "The EBA has recently identified a €135bn capital shortfall. These estimates are subjective, have been reviewed several times and may well increase," he says.

He continues: "While larger banks will have several years to adjust, standardised banks will be affected in full from 2022. Having spent a decade to review synthetic securitisation rules, it would be a pity if this tool was not practically available for all banks to meet the Basel 4 deadline."

About €100bn of IRB loans are synthetically securitised each year. Standardised bank SRT issuance volumes pale in comparison, underlining that bottlenecks remain.

"Bank demand for capital is robust and investor capacity is available from both traditional sources, such as hedge and pension funds, as well as re/insurers – which now represent about a third of the US synthetic securitisation market. The US example shows that the risk transfer market could see significant growth, given the right conditions. Standardisation of contracts and certainty of regulatory approval would help develop the European synthetic securitisation sector greatly," Giovannetti concludes. ■