Holding steady

Recent banking instability is unlikely to result in contractual changes in synthetic securitisations, but structural divergences are emerging. **Stelios Papadopoulos** investigates.

The aftermath of UBS's acquisition of Credit Suisse and the turmoil in the US regional bank market is unlikely to result in any contractual changes around counterparty credit risk in synthetic securitisations. However, opinion is divided over the importance of rating triggers, while the US market appears to be diverging towards the use of SPV structures rather than direct CLNs. Perhaps more saliently, issuance from smaller regional banks on both sides of the Atlantic could decline over the medium term, due to investor preferences for larger and more systemic bank issuers.

Synthetic securitisations can be structured as bilateral guarantees, SPVs or direct CLN structures. Under a bilateral guarantee, the bank enters into a credit default swap directly with the investor, which fully collateralises the CDS (unless they are an insurer).

SPV structures issue CLNs and sell credit protection on the underlying portfolio, before placing cash on deposit with the issuing bank. Finally, direct CLN structures are CLNs issued off the bank's balance sheet, meaning that the noteholder has direct exposure to the bank.

Direct CLN structures have come to dominate the CRT market, since they are the simplest and most cost-effective structure for issuing banks. Establishing an SPV involves high set-up and administrative costs, but under an SPV structure, CRT investors rank pari passu with unguaranteed depositors. Direct CLN investors, on the other hand, rank pari passu with unsecured debtholders.

However, it's important to qualify that that direct CLN notes are senior preferred debt. Matthew Moniot, co-head of credit risk sharing at Man Group, explains: "Structured notes, including synthetic securitisations issued under a CLN structure, rank as senior preferred debt equal to deposits and derivative collateral. Senior preferred bonds are not TLAC/MRE-eligible and, consequently, should be protected from a potential bail-in – unlike AT1 bonds, equity and other subordinated instruments."

Total loss absorbing capacity (TLAC) is an international standard, finalised by the Financial Stability Board (FSB) in November 2015. The aim of the standard is to ensure that globally systemically important banks (G-SIBs) have enough equity and bail-in debt to pass losses to investors and minimise the risk of a government bailout. Instruments that count as TLAC need to be able to be written down or converted into equity to recapitalise the entity as it goes through resolution. ▶

Robert Bradbury, Alvarez & Marsal

Figure one: BRRD creditor hierarchy

Guaranteed deposits	
Non-guaranteed deposits (individuals and SMEs)	
Deposits (wholesale and institutional)	Senior preferred debt
Senior non-preferred debt	
Subordinated debt	
Tier 2 securities	
AT1 securities	
Equity	

Source: Scope Ratings

MREL, on the other hand, is more EU-specific and was conceived as part of the Union's Bank Recovery and Resolution Directive (BRRD). The BRRD introduces a resolution framework with tools for dealing with failing banks, requiring them to produce recovery plans and granting supervisors sweeping powers to intervene when lenders are experiencing a period of stress.

MREL ensures that banks have sufficient capacity to absorb losses, so that they can fail safely, thereby reducing the need for a public sector recapitalisation. The requirement can be met through both equity and/or loss-absorbing debt.

The legal language around senior preferred versus senior non-preferred debt is more relevant in an EU context, with other jurisdictions – such as the UK – utilising the OpCo/HoldCo structure. However, CLN notes in these juridictions would sit in the OpCo, which would in principle amount to the same type of seniority as senior preferred debt. Where the CLN note sits in a bank's capital structure is also a function of jurisdictional differences and the idiosyncrasies of individual issuers and deals.

Moreover, regulators can occasionally leverage legal ambiguity, depending on circumstances. ''While the US FDIC can only insure deposits up to US$250,000, recent US banking turmoil demonstrated that the definition of a large, systemic bank can be flexed when needed,'' remarks Moniot.

Yet this is why investors overall prefer to execute transactions with large, globally systemic banks, where loss-absorbing capital definitions are more specific and there's an explicit understanding that regulators won't allow such banks to unwind -as evidenced by the case of Credit Suisse – but will instead go through a controlled resolution. The BRRD in Europe, for example, would aim to reduce liabilities via equity and AT1 write-downs, although banks could still see their Tier 2 get wiped out.

Furthermore, smaller lenders don't tend to trade in CDS, so investors can't use that tool to hedge counterparty credit risk. Nevertheless, the track record of synthetic securitisations undertaken with smaller banks remains solid.

For example, PacWest's mortgage transaction – which was finalised last year – saw cash deposited in a Citi account. Yet this depends on each case, since smaller banks can alternatively simply post collateral in the form of high-quality securities.

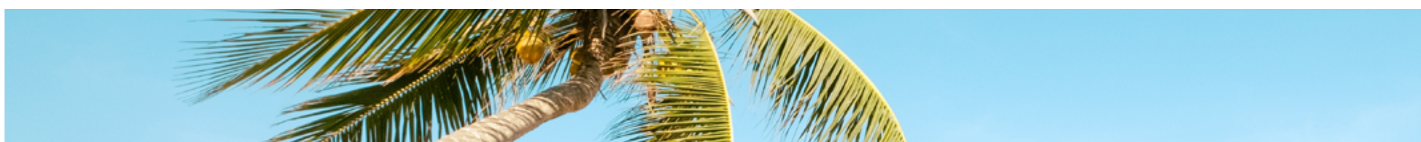
However, third-party accounts have their issues. Robert Bradbury, head of structured credit at Alvarez & Marsal, explains: ''Depositing cash in a third-party bank account increases the operational burden overall for the bank, given the additional lines of communication and parties involved with routine monitoring of defaults and associated cashflows. It also comes with the potential for higher RWAs associated with the account bank counterparty credit risk, which can be mitigated, but adds one more layer of structure.''

> "DEPOSITING CASH IN A THIRD-PARTY BANK ACCOUNT INCREASES THE OPERATIONAL BURDEN OVERALL FOR THE BANK"

For instance, Banco Espirito Santo – which collapsed in 2014 – was restructured into its successor entity Novo Banco, but the lender's capital relief trades continued to pay CDS premiums while in resolution and following its sale. The same is true for Banco Popular in 2016, after it was acquired by Santander, and more recently Getin Noble Bank *(SCI 3 November 2022)*.

If there is no 'event of default' or liquidation of the bank and the CDS premiums continue to be paid, the credit protection persists. The difference with smaller, regional banks is that investors might prefer to deposit cash in third-party bank accounts.

Additionally, ''depositing cash in third-party bank accounts rarely happens, since originators don't get funding. Small banks may be just required to post collateral in the form of high-quality securities, since it's unlikely that investors would want to take senior unsecured risk for the



Olivier Renault, Pemberton Asset Management

life of the transaction," says Olivier Renault, head of risk sharing at Pemberton.

Rating triggers are another alternative that has been discussed. According to one SRT investor: "When you enter an SRT contract, there may be clauses to protect from counterparty credit risk, such as a requirement to move the cash deposit to another bank if the issuer's rating falls below an identified threshold, and this must typically happen within 60 to 90 days. This used to be common prior to the 2008 financial crisis, but since then a lot has changed."

"DOWNGRADE TRIGGERS ARE CONSIDERED POINTLESS BY SOME SRT INVESTORS, BUT IT HELPS YOU IN A TAKEOVER SCENARIO"

The investor continues: "The issue here is that banks can jump to default prior to a ratings downgrade. Moreover, moving the collateral to another account isn't straightforward and takes time."

Nevertheless, some investors do see value in rating triggers. "Downgrade triggers are considered pointless by some SRT investors, but it helps you in a takeover scenario, such as UBS's acquisition of Credit Suisse. During this scenario, the rating of the bank changes with a new rating that might fall below expectations. So, rating triggers preserve the rating quality of the collateral," states James King, portfolio manager at M&G.

Overall, whatever structural tweaks the sell-side and the buy-side end up agreeing, direct CLNs will likely remain the dominant CRT structure, given the lower costs of setting them up – although this is not certain for the US market. JPMorgan, for instance, is readying a synthetic securitisation that will be an SPV structure and US regulators seem to prefer them over direct CLNs *(SCI 19 April)*.

US regulators put the CRT market on hold last year, given alleged concerns over direct CLN structures and the presence of call features. Consequently, JPMorgan's transaction would be the first deal executed for capital relief purposes in over a year.

Questions though linger from a supervisory standpoint as to whether an SPV has ownership of the collateral and pledges to fully repay the notes to the bank and then the investors. Another question more salient for originators is whether banks must comply with swap regulations, since the SPV can be considered as a commodity pool.

Another important development going forward will be growing significant risk transfer issuance, given the challenges in the AT1 market following the wipe-out of Credit Suisse's AT1 securities in March. Last year saw record issuance, with 87 transactions in total *(SCI 30 March)*.

AT1s were believed to be senior to equity in bank capital structures, so the write-down of the CS AT1 bonds to zero while the equity holders received a payment came as a shock to many investors and caused substantial disruption in the AT1 market. Supervisors such as the ECB rushed to clarify the ranking of AT1 bonds after the event via public statements, but spreads are high and are likely to remain so for some time, according to a recent Seer Capital report.

Looking ahead, the Seer report concludes: "Total outstanding AT1 debt is more than US$250m, with many European banks having relied on the instruments for a meaningful portion of the capital they are required to hold. Inability to issue AT1s will leave banks with a meaningful capital shortfall, for which they will need to turn to reg cap, at least in part."

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