End of the line?

The requirement to fully capitalise synthetic excess spread is expected to result in SRT issuers dropping the feature from their transactions. **Stelios Papadopoulos** weighs the relative benefits of synthetic securitisations versus those of full-stack cash deals, in which originators can use excess spread.

The EBA and the European Commission's decision last year to fully capitalise synthetic excess spread will likely force banks to drop the feature from significant risk transfer transactions going forward ***(SCI 24 December 2020)*****. While the new rules do not pose a threat to new issuance – especially when most banks do not use the structural feature – they will render capital relief trades less efficient and this is particularly true for existing deals. Nevertheless, the relative benefits of synthetic securitisations still outweigh those of full-stack cash deals, in which originators can use more excess spread.**

The new treatment of excess spread was first laid out in the EBA's final report on significant risk transfer in November 2020. The report builds on the 2017 discussion paper and the lessons learned since then; most notably, the divergent regulatory practices in connection with SRT, which was particularly pertinent in the case of the treatment of excess spread.

Some supervisors believed that on day one of a transaction, banks should quantify excess spread and sell a portfolio below or above par. However, others thought that lenders should sell the portfolio at par, with any remaining income flowing back to the originator over time.

The key issue from the EBA's perspective was ensuring that excess spread is not too high for the purposes of meeting the commensurate risk transfer tests. SRT tests are typically divided into two sets of tests. The first, dubbed the mechanistic tests, require banks to demonstrate that they have transferred 80% of the first loss tranche and at least 50% of the mezzanine tranche.

The commensurate risk transfer tests form the second set and are used to gauge whether the capital relief is proportional to the transferred risk. The issue is not that puzzling in the case of full-stack transactions, since banks achieve market pricing by selling the whole stack and therefore prevent any situation where excess spread could be artificially inflated to support the junior tranches. ▶

However, what happens if an originator retains the senior tranche – as in the case of a synthetic securitisation – and how banks ensure that the coupon is correct in that situation was unclear. If it is too low, it implies that excess spread is being used to support the mezzanine and junior tranches. Banks therefore need to prove that the coupon is market priced and proving that is where the EBA's SRT report offers a helping hand.

The final report does this by treating synthetic excess spread as a retained first loss tranche that is risk weighted at 1250% – which effectively amounts to a full capital charge, plus deduction, and captures lifetime expected losses. The resulting commensurate risk transfer tests then incorporate synthetic excess spread, since – if banks want to pass them – they should account for the nominal value of the first loss tranche and the retained synthetic excess spread position.

Pablo Gonzalez Sanchez, EIF

"IF I HAD TO CHOOSE BETWEEN TRUE SALE AND SYNTHETIC, I WOULD STILL OPT FOR SYNTHETICS, GIVEN THE COSTS OF SETTING UP AN SPV"

The European Commission incorporated the EBA's proposals in its 'quick fix' regulation *(SCI 31 July 2020)*, which was passed into law in December 2020 *(SCI 24 December 2020)*.

The new rules are not expected to pose a threat to new issuance, but could reduce the efficiency of transactions. According to an arranger: ''If the EBA clarifies that future excess spread should only be deducted from capital if it's higher than expected losses, then that's something that can work, but excess spread isn't the most important feature in a transaction. If the proposed regulation is not amended, there will still be issuers that opt for a synthetic trade, but with a thicker junior tranche and slightly higher cost of capital.''

He continues: ''If I had to choose between true sale and synthetic, I would still opt for synthetics, given the costs of setting up an SPV; you just do the deal without the excess spread and build in a thicker junior tranche. However, a thicker junior tranche means that the economics will deteriorate, especially for existing deals with synthetic excess spread. Here, grandfathering would be essential, since you must account for both future excess spread and a thicker tranche – but that is unlikely to happen.''

Another concern is the commensurate risk transfer tests. A structurer states: ''The new tests stipulate more conservative backloaded scenarios that would stop many deals from passing them. In fact, one of the tests requires severe backloaded scenarios that would kill pro-rata amortisation deals, even if they have triggers to sequential."

The structurer adds: "The new scenarios effectively amount to sink hole insurance for a mortgage. Addressing this would require either relaxing the rules on the high cost of credit protection or softening the ones on pro-rata amortisation.''

Indeed, the new rules will reduce capital relief and raise the cost of protection, since banks will now free up much less capital for the same coupon payments. EIF transactions are especially vulnerable, given how often the fund uses synthetic excess spread in its trades.

Pablo Gonzalez Sanchez, structured finance manager at the EIF, explains: ''Unlike private investors, the EIF has a predefined risk appetite, depending on the mandates to be implemented. It is for that reason that we often need a minimum attachment point and/or excess spread to be able to guarantee a synthetic securitisation tranche. We do not have the freedom private investors have to attach at any point in the capital stack – including 0% attachment – and charge a fee according to it.''

He continues: ''In other words, we cannot compensate risk-taking with pricing and therefore we often – but not always – need a little more protection on our tranches, so we need subordination and therefore excess spread. The current treatment is to limit excess spread to one-year expected loss in use-it-or-lose-it format, but the new rules will frontload excess spread to the point where it's equal to lifetime expected losses and then capitalise it. This effectively double-counts reserves, both provisions and unexpected losses, so it's going to be a sea change from today where you only provision annually.''

If the SRT rules are not clarified and excess spread is eventually frontloaded and fully capitalised, many potential standardised bank deals are likely to be left out of the market and a gap in supranational SME funding could materialise. Still, if the transactions end up being in line with the cost of capital, then it is business as usual. Yet

Robert Bradbury, StormHarbour

He states: ''The potential use of partial placement is significant because some banks would rather fund their portfolios through other means and particularly TLTROs, since usually there's not enough true sale origination to recycle cash. Partial placement will be of great use in this respect.''

However, most lenders contacted by SCI have disputed the potential of partially placed transactions. One reason is that the ECB now just simply will not accept them, due to its preference for full-stack true sale structures.

This then leaves a window open for full-stack deals. But besides the attendant complexities of setting up an SPV and losing borrower relationships, non-granular asset classes that are typically referenced in synthetics – such as SME and corporate loans – don't generate enough excess spread in the cash format. Yet the scenario is quite different for consumer and auto loans.

''We will likely see more full-stack true sale transactions for high-yielding consumer loans, where excess spread can be high, and with structures that allow banks to use more of it as a buffer against future losses. However, excess spread is limited in the case of SMEs and corporates,'' says Sanchez.

Perhaps more saliently, originators can continue to adhere to the synthetic format but just adjust their portfolios. Robert Bradbury, head of structuring and advisory at StormHarbour, explains: ''If you want to mitigate the more challenging provisions of the new SRT tests, including the excess spread rules, one way is to start from a high-quality portfolio for which excess spread is of limited use or not required when investors underwrite and determine the pricing.''

He adds: ''On the other hand, if this approach is not applicable, in the absence of excess spread for some pools, issuers are likely to pay more to hedge the same tranches, or alternatively may add retained first loss tranches. However, the retained piece will make the transaction significantly less efficient, all else equal.''

"WE WILL LIKELY SEE MORE FULL-STACK TRUE SALE TRANSACTIONS FOR HIGH-YIELDING CONSUMER LOANS, WHERE EXCESS SPREAD CAN BE HIGH"

The industry will have to wait until the publication of the RTS for more clarity. The nature and extent of the negative impact remains to be seen, as although it is expected that there will be a tranche that represents excess spread and will be risk weighted as a securitisation exposure, the calculation of that amount remains a mystery. The RTS is due to be published in the second half of this year.■

transactions without excess spread will reduce the flexibility of the protection.

The EIF will continue to grow its securitisation footprint under the new European Guarantee Fund (EGF). The latter is designed to support viable EU businesses that under normal circumstances would have been able to acquire a loan but are now going through challenging times due to the economic downturn.

Sanchez confirms: "We are discussing with the relevant stakeholders the allocation of certain funds from the EGF to the EIB Group's securitisation business, potentially allowing for guarantees on first loss pieces or mezzanine tranches with a much lower attachment, in exchange for a much higher commitment from the beneficiaries – banks – to deploy new lending to SMEs in the EU. The final decision on this facility is expected within the next couple of months.''

The new rules offer a relative advantage to full-stack true sale deals, where excess spread can be used more freely and now also permit partially placed true sale securitisations that could offer more flexibility to originators that want to retain their senior tranches via cash structures. Another arranger says that the EBA would allow banks to retain the senior tranche, although the agency's final SRT report does not clarify how to practically achieve market pricing.

The market may have to wait for the first deals and the reaction of NCAs to glean a clearer picture. Still, the same structurer is confident that granular and vanilla deals will pass the SRT tests.

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