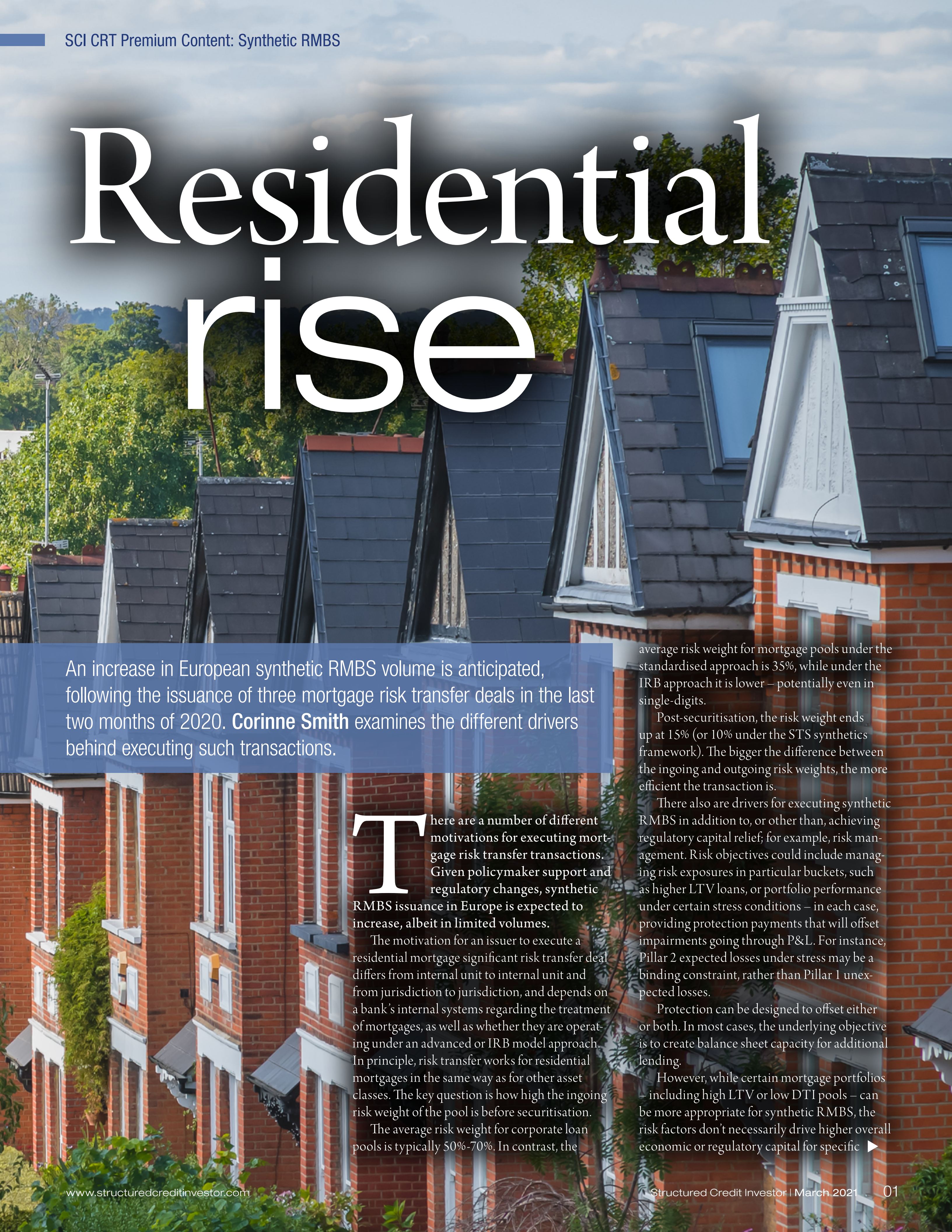

Residential rise

An increase in European synthetic RMBS volume is anticipated, following the issuance of three mortgage risk transfer deals in the last two months of 2020. **Corinne Smith** examines the different drivers behind executing such transactions.

There are a number of different motivations for executing mortgage risk transfer transactions. Given policymaker support and regulatory changes, synthetic RMBS issuance in Europe is expected to increase, albeit in limited volumes.

The motivation for an issuer to execute a residential mortgage significant risk transfer deal differs from internal unit to internal unit and from jurisdiction to jurisdiction, and depends on a bank's internal systems regarding the treatment of mortgages, as well as whether they are operating under an advanced or IRB model approach. In principle, risk transfer works for residential mortgages in the same way as for other asset classes. The key question is how high the ingoing risk weight of the pool is before securitisation.

The average risk weight for corporate loan pools is typically 50%-70%. In contrast, the average risk weight for mortgage pools under the standardised approach is 35%, while under the IRB approach it is lower – potentially even in single-digits.

Post-securitisation, the risk weight ends up at 15% (or 10% under the STS synthetics framework). The bigger the difference between the ingoing and outgoing risk weights, the more efficient the transaction is.

There also are drivers for executing synthetic RMBS in addition to, or other than, achieving regulatory capital relief; for example, risk management. Risk objectives could include managing risk exposures in particular buckets, such as higher LTV loans, or portfolio performance under certain stress conditions – in each case, providing protection payments that will offset impairments going through P&L. For instance, Pillar 2 expected losses under stress may be a binding constraint, rather than Pillar 1 unexpected losses.

Protection can be designed to offset either or both. In most cases, the underlying objective is to create balance sheet capacity for additional lending.

However, while certain mortgage portfolios – including high LTV or low DTI pools – can be more appropriate for synthetic RMBS, the risk factors don't necessarily drive higher overall economic or regulatory capital for specific ▶

mortgages. This is because many lenders will compensate with tighter criteria in respect of other underwriting criteria or collateral requirements.

A synthetic RMBS can also be executed for economic capital purposes, albeit few banks currently attach value to economic risk transfer independent of regulatory capital relief. Nevertheless, regulatory constraints can force conservative structural choices that are not necessarily efficient for some issuers, increasing their costs and reducing commercial flexibility. In these cases, a transaction targeting economic capital only can be calibrated to the specific requirements of risk teams.

At its simplest, lenders will compare the marginal cost of protection against the marginal benefit of redeploying the capacity freed by that protection – whether that is regulatory capital, economic capital or risk limits.

Notably, three synthetic RMBS closed in 4Q20. Together with the third transaction from Lloyds' Syon programme *(SCI 19 November 2020)*, AXA Bank Belgium priced CASPR-1 – which references a static €730m portfolio of Belgian prime mortgages *(SCI 2 December 2020)* – and Raiffeisen completed ROOF Mortgages 2020, a €182m unfunded mezzanine guarantee referencing a static €3.3bn portfolio of Austrian residential mortgages *(SCI 7 December 2020)*.

Salim Nathoo, partner at Allen & Overy, notes that risk transfer isn't normally utilised in the context of prime mortgages, since they are

Salim Nathoo, Allen & Overy

low risk weighted assets. "SRT is more commonly undertaken with riskier mortgages, such as non-conforming or subprime, and high LTV mortgages because they have higher risk weights. However, even high LTV mortgages have a low default history, and losses correlate to a decline in property values. They are relatively fungible pools and so are typically easy to model and work out the loss exposure."

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Furthermore, residential mortgages have historically been somewhat overlooked among SRT issuers because corporate loan portfolios have created better efficiencies. However, the coronavirus pandemic has created greater uncertainties in corporate loan pools.

Against this backdrop, residential mortgage pools are granular – which is attractive to investors – and the loans are collateralised. Additionally, house prices continue to perform well and so seeking optimisation opportunities in the sector is becoming more appealing – especially since banks have to begin incorporating through-the-cycle (TTC) PDs (rather than point-in-time PDs) when modelling risk weights under Basel 4. Over time, TTC risk weights tend to rise in certain pools, including residential mortgages.

Indeed, the introduction of capital floors under Basel 4 – which will increase mortgage risk weights – is expected to increase the attractiveness of capital management tools for banks. Nathoo confirms that a number of prospective issuers are ensuring they have the ability to execute SRT deals over the next few years and are having conversations with regulators in preparation for this.

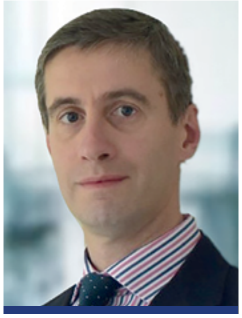
He suggests that there are a couple of drivers for banks in this regard. First is pricing: it is clear that there is an investor base for mortgage SRT, especially with insurers increasingly entering the market.

Second, when Covid support schemes end, there will be a number of distressed businesses and borrowers, and bank capital will come under pressure. "Banks will need to begin provisioning and thinking about balance sheet management. This will likely take the form of a combination of strategies, including SRT," Nathoo says.

Further, the STS synthetics regime – which is expected to come into force this summer – could also make residential mortgage SRT more attractive. Residential mortgage pools tend to be homogeneous and will therefore meet the strict homogeneity criteria of the STS label – unlike corporate pools, for example, which often combine SME, project finance, mid-cap and large cap exposures.

However, another issue triggered by the Covid fallout is that portfolios are behaving in unexpected ways – meaning that it is difficult for both originators and investors to commit to deals. "Depending on the moratoria that apply to the underlying assets, issuers may not be able to call defaults, so there is potentially less incentive to execute SRT transactions. Static deals aren't as efficient because issuers are unable to replenish the pool," Nathoo observes.

Indeed, the big question for issuers at present is whether they can execute deals, especially in the corporate loan space. While investors are



Giuliano Giovannetti, Granular Investments

pushing for fully disclosed pools, given uncertainties around the Covid fallout, many issuers are more comfortable with blind pools – albeit they are willing to provide information on large concentrations and so on.

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A further issue is investors requesting issuers to exclude Covid-sensitive industry exposures from pools. If too many names are carved out of a portfolio, it may end up being too uneconomical to execute an SRT. Against this backdrop, more synthetic RMBS are expected to be executed, but in limited volumes.

Nathoo agrees that further synthetic RMBS issuance is likely going forward, especially given the policymaker push towards making mortgages more available to borrowers that can't afford a deposit. "For instance, the market is seeing a greater push in the UK for higher LTV products typically up to 95% as an alternative to help-to-buy. The higher the associated risk weights are, the more it becomes worthwhile bringing a synthetic or full-stack RMBS that obtains capital relief."

Some providers are providing alternative solutions to allow higher LTV lending or accommodate first-time buyers, such as second-charge mortgage products typically lending on the 75%-95% portion of a mortgage or providing cheaper longer-dated fixed rate mortgages, with prepayment penalties falling away after a fixed period. "Non-bank mortgage lenders are building capital markets strategies and increasingly entering the high yield segment. Banks, for their part, are exploring opportunities to partner with these non-bank lenders and share the risks and rewards," Nathoo observes.

At the same time, the cost of buying protection is potentially lower than for other asset classes and investors are interested in gaining exposure to residential property because of the yield on offer. For many, the choice is to buy mezzanine or equity positions in cash securitisations or provide protection in synthetic securitisations.

Giuliano Giovannetti, md at Granular Investments, agrees that there are certainly opportunities for issuers to undertake risk transfer deals on residential mortgages. However, he suggests that they are unlikely to compensate for corporate SRT deal volume, should that dry up.

"The vast majority of residential portfolios earn low spreads and are under IRB, with risk weights near or below even the 10% STS senior risk weight floor, so releasing capital is difficult. There are pockets of more appropriate pools here and there under IRB, as well as opportunities on mortgages under the standardised approach," he notes.

Similarly, while Basel 4 suggests increasing RWAs – in particular, for high LTV loans – he points to uncertainty over how the regime will be implemented in Europe. "European banks aren't going to allow their capital to be devastated by an egregious increase in risk weights, especially on mortgages, where the culprit is clearly the US. Any BIS proposals are unlikely to be automatically ratified by the European Parliament, which has already submitted substantial amendments in the opposite direction," Giovannetti indicates.

Overall, Allen & Overy senior associate Robert Simmons suggests that the proliferation of risk transfer technology into the residential mortgage sector is a natural progression of the market. "Risk transfer technology is tried and tested in the SME and corporate loan spaces, and we have been seeing it expand across more asset classes – a continuation of the trend from, amongst others, auto loans. New areas where the technology makes sense continue to emerge. Executing an SRT transaction still remains challenging for first-time issuers, but as the technology is increasingly proven, it will become more common."

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