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Autumn 2020

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London, September 2020

Welcome to the fourth quarterly SCI Research Report on the capital relief trades market. Part of SCI's premium subscription package, this series of reports aims to provide in-depth analyses of topical themes and trends being discussed in the sector.

This quarter, we explore the utility of significant risk transfer for the real economy. The European SME sector is being impacted in a multitude of ways by the Covid-19 pandemic, yet policymakers believe that SMEs can play a crucial role in the post-coronavirus economic recovery.

Indeed, SMEs are viewed as the backbone of the European economy, due to their contribution to employment and job growth. Since SMEs depend mostly on bank financing and one lending tool banks have is securitisation, the technology finally appears to be garnering acceptance and support by the authorities – especially as synthetics transfer risk and free up bank balance sheets for further lending. As such, the missing pieces of the securitisation regulation – including STS for synthetics and a workable SRT regime, for which the industry has been calling for years – are being fast-tracked.

However, the SME sector has high concentrations in crisis-exposed industries, such as tourism and retail. Not only are SME default rates likely to increase due to the Covid-19 fallout, widespread payment moratoria are also affecting the segment.

Consequently, while the SME asset class has historically accounted for a meaningful portion of SRT volumes, the current environment is challenging in terms of creating a stable reference portfolio. Against this backdrop, the EIF has stepped up and is expecting its issuance this year to easily double that issued under normal circumstances. Whether private investors return to the sector in Q4 remains to be seen.

This report outlines the case for SME SRT, the policymaker initiatives that aim to support the sector, the challenges to and potential solutions for enabling it to reach its potential, and the role of the EIF.

While the CRT market navigates this new course, we hope you remain safe and well.

Happy reading!

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Securitisation innovation in focus

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CHAPTER ONE: INTRODUCTION

The European SME sector is being impacted in a multitude of ways by the Covid-19 pandemic. Yet policymakers believe that SMEs can play a crucial role in the post-coronavirus economic recovery and are supportive of measures that can strengthen their position. As part of such efforts, the final pieces of the securitisation regulation – for which the industry has been calling for years – are being fast-tracked, with an emphasis on synthetics.

Backbone of the economy

European institutions view SMEs as the backbone of the European economy, due to their contribution to employment and job growth, according to Cadwalader special counsel Assia Damianova. "SMEs depend mostly on bank financing and one lending tool banks have is securitisation. Securitisation is being supported by the authorities in light of the state of the economy currently, especially as synthetics transfer risk and free up balance sheets," she says.

She adds: "When European regulators think of synthetics, SMEs are often at the forefront of their analysis, due to their importance to the economy. Given that in Europe, SME lending is concentrated in banks, it's a logical step to try to support the sector through tools that will allow banks to extend more loans to SMEs."

A recent EIF Working Paper, entitled 'European Small Business Finance Outlook 2020', notes that a "real recovery and development of the primary securitisation markets could play a role in ensuring sufficient credit supply for SMEs during the crisis and the recovery process". The paper highlights that in addition to the direct effects of the SME securitisation market, there are indirect benefits to SMEs from the development of other securitisation segments that free up bank balance sheets to allow for further SME lending. However, it argues that this will only benefit SMEs if the freed-up capital is used to finance the real economy.

> "SMES DEPEND MOSTLY ON BANK FINANCING AND ONE LENDING TOOL BANKS HAVE IS SECURITISATION"

Assia Damianova, Cadwalader

Covid challenges

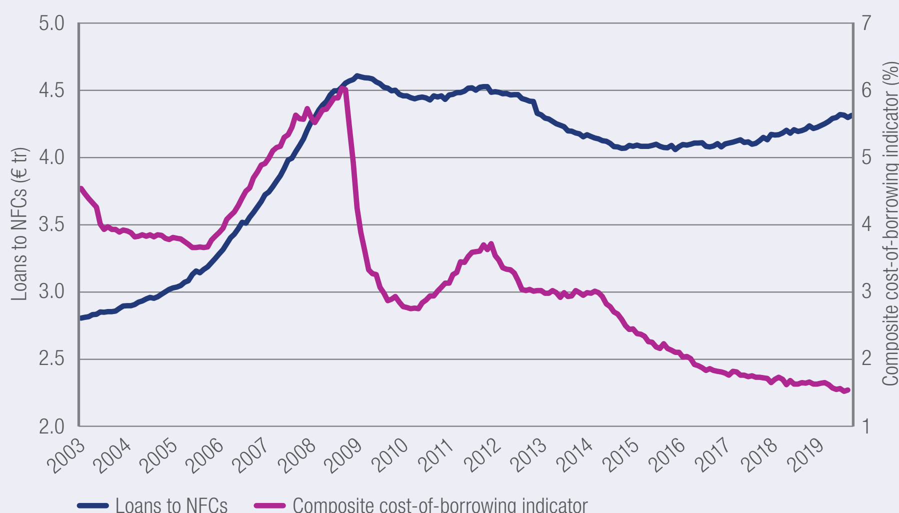
The EIF paper also summarises the numerous challenges that European SMEs – and by extension, SME securitisations – face, following the Covid-19 fallout. Not only are SME default rates likely to increase and have a related impact on SME securitisation portfolios, widespread payment moratoria are also affecting the sector.

Additionally, some SME securitisations have high concentrations of underlying companies in crisis-exposed industry sectors, such as tourism and retail. Moreover, SME leverage will increase with potential long-term debt affordability issues, especially in jurisdictions that experience a slow recovery from current disruptions.

The SME asset class has historically accounted for a meaningful portion of significant risk transfer volumes, at around a third of issuance. In terms of the number of trades executed, there are believed to be more SME deals than in other SRT asset classes.

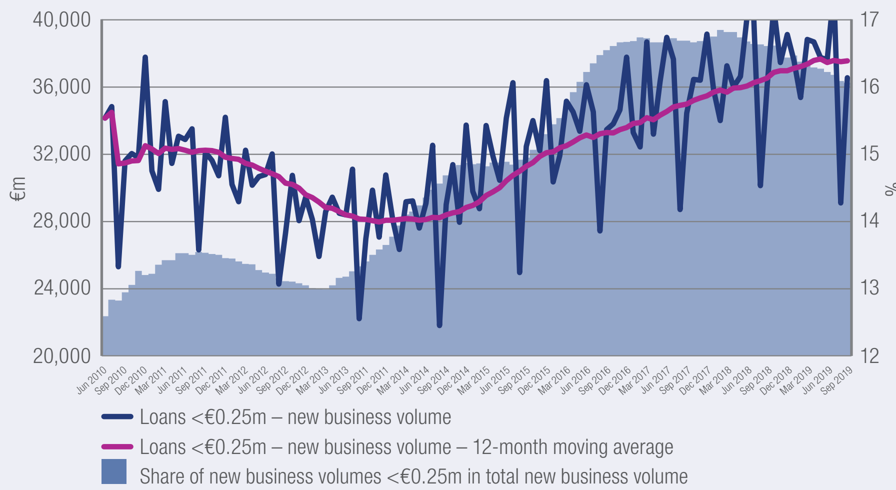
Through an SME SRT deal, investors generally benefit from taking exposure – in exchange for a premium – to a bank's SME lending business (which they cannot access directly) and can take advantage of the expertise of banks in managing such portfolios. SME pools typically

Outstanding loans and composite cost-of-borrowing indicator for non-financial corporations in the Euro area



Source: EIF: European Small Business Finance Outlook 2019

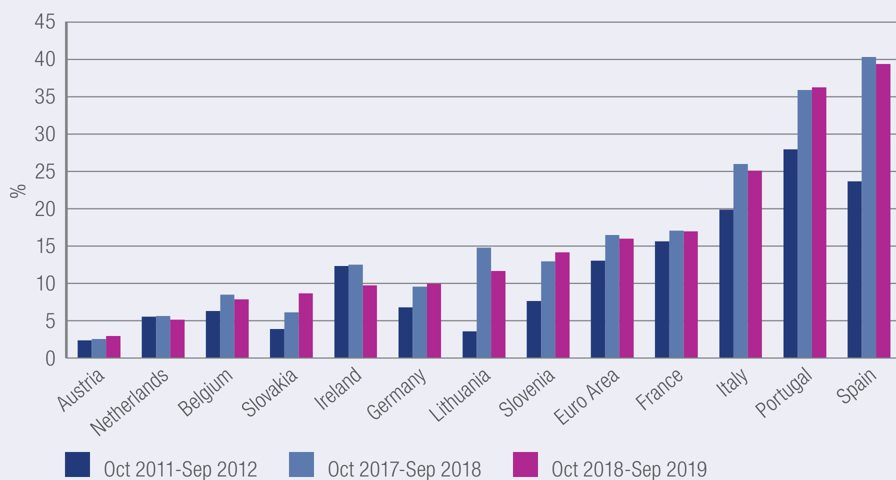
Small loans to NFCs, new business volumes in the Euro area



Source: EIF: European Small Business Finance Outlook 2019

"TODAY, HISTORICAL PERFORMANCE IS LESS RELEVANT, AS THE IMPACT OF THE PANDEMIC AND THE SUBSEQUENT LOCK-DOWN WILL BE DIFFERENT TO WHAT WE HAVE OBSERVED DURING THE GLOBAL FINANCIAL CRISIS"

Small loans as a share of total NFC lending, by country*



* NBV: New business volume, 12 months backward moving average

Source: EIF: European Small Business Finance Outlook 2019

comprise a large number of small loans, which have to be diligenced and representations provided, confidentiality issues have to be overcome and historical performance data has to be prepared to the highest quality.

Damianova notes that across jurisdictions, there is some fragmentation in terms of SME insolvency and enforcement regimes. Default and loss rates also tend to be slightly higher for SMEs than other asset classes, although this can be compensated for in pricing.

Prior to the Covid-19 pandemic, the main requirement for a successful European SME SRT transaction for IRB banks was having sufficient quantity and quality of data to support their expected loss assumptions. "Banks could achieve reasonable pricing by evidencing the predictability of their regulatory models," explains Kaikobad Kakalia, cio at Chorus Capital.

However, he adds: "Today, historical performance is less relevant, as the impact of the pandemic and the subsequent lock-down will be different to what we have observed during the global financial crisis or the European sovereign crisis. Given the uncertainty involved in portfolio selection, investors will look for transactions with greater subordination, thicker tranches and higher pricing."

Regulatory initiatives

Meanwhile, a pair of initiatives were unveiled during the summer that include measures to encourage a broader use of securitisation, especially in light of facilitating a coronavirus recovery: the final report by the High Level Forum on Capital Markets Union (CMU) in June; and the European Commission's capital markets recovery package (dubbed the 'quick fix') in July. Both proposals aim to make it easier for capital markets to support European businesses, but the High Level Forum report explicitly highlights the limited capacity of bank balance sheets to extend funding to SMEs as one issue to be resolved in order to complete the CMU.

Ganesh Rajendra, Integer Advisors

CASH OR SYNTHETIC?

SME loans are typically more difficult to securitise via a true sale format, as they can be challenging from a credit perspective, are typically less homogeneous than mortgages, for instance, and are often revolving facilities or linked to other banking products. This can make the cashflows harder to track in a cash securitisation.

In comparison, synthetic SME transactions have proven to be simpler, due to the lower legal and operational complexity involved. "Cash transactions require the true sale of assets to be segregated in an SPV established for that purpose and the involvement of a greater number of parties in the deal; for example, liquidity provider, back-up servicer, trustee or paying agent and hedging counterparty for interest rates mismatches," observes Biagio Giacalone, head of the active credit portfolio steering unit at Intesa Sanpaolo. "Therefore, structuring and ongoing costs are generally lower than for traditional transactions, as fewer parties are involved in the transaction and no official ratings on tranches are required. In the absence of an SPV involved, no additional ongoing costs are borne by the originator."

Additionally, the transfer of the portfolio requires significant legal analysis, as the underlying exposures need to be effectively segregated from the seller, its creditors and liquidators, for the investors to have an effective recourse on the portfolio (if necessary) and to avoid any risk of claw-back. Indeed, a synthetic transaction – in its simplest form – only requires the protection contract to be exchanged between the parties, which must design how the risk transfer is achieved.

One of the main advantages of synthetic transactions is that the reference portfolio remains on the bank's balance sheet, so that the bank continues to be in charge of originating, monitoring and servicing the loans and of managing the overall relationship with clients. This represents a core activity and a core expertise of originators, especially when portfolios consist of assets that represent the core business of the bank, according to Giacalone.

Another advantage of synthetics over true sale deals is that the structuring process is more flexible, as generally synthetic transactions are private deals involving specialised investors, often on a bilateral basis or with a restricted number of investors for each deal. A dialogue between investors and the originator allows for a tailor-made transaction that can fulfil the objectives of both parties.

Ganesh Rajendra, managing partner at Integer Advisors, says it is encouraging to see the improving policymaker stance regarding securitisation. "Given the urgent need for a post-Covid economic recovery, the policymaker mindset seems to have switched from de-risking and controlling securitisation to using it more proactively to improve the real economy. But although there are good intentions behind the Capital Markets Union project, I'm cautious about its execution, given the piecemeal implementation approach historically taken by regulators."

The remainder of this report explores the case for SME SRT, the regulatory initiatives designed to support the sector, the challenges to and potential solutions for enabling it to reach its potential, and the role of the EIF.■

"GIVEN THE URGENT NEED FOR A POST-COVID ECONOMIC RECOVERY, THE POLICYMAKER MINDSET SEEMS TO HAVE SWITCHED FROM DE-RISKING AND CONTROLLING SECURITISATION TO USING IT TO IMPROVE THE REAL ECONOMY"

CHAPTER TWO: SRT FOR THE REAL ECONOMY

The urgent need to address the Covid-19 economic fallout has accelerated efforts to 'fix' the securitisation market, including the fast-tracking of an STS synthetics regime. Policymakers appear to recognise that synthetic securitisation, in particular, is an important and efficient way of transmitting resources to SMEs and the real economy.

"From a policymaker perspective, whereas post-financial crisis banks were seen to be at the centre of the problem, they now appear to be at the centre of the solution. Banks are healthier and therefore there is greater confidence to provide leeway to transfer risk, especially given that the EBA paper provides a benchmark in terms of best practice," observes Steve Gandy, md and head of private debt mobilisation, notes and structuring at Santander.

> "FROM A POLICYMAKER PERSPECTIVE, WHEREAS POST-FINANCIAL CRISIS BANKS WERE SEEN TO BE AT THE CENTRE OF THE PROBLEM, THEY NOW APPEAR TO BE AT THE CENTRE OF THE SOLUTION"

Supporting economic growth

Biagio Giacalone, head of the active credit portfolio steering unit at Intesa Sanpaolo, agrees that in the current exceptional circumstances, banks play an even more vital role in supporting the real economy. "Through SRT transactions, banks are able to free up capital that can be reused through loans to the real economy and, in particular, to SMEs that benefit most from these operations. In this way, SRT transactions are able to provide benefits also in terms of financial stability and jobs retention, resulting in a more favourable economic landscape."

Giacalone acknowledges that EU legislators have rightly introduced many safeguards to the securitisation market to prevent another financial crisis occurring. But he indicates that perhaps it is time to reassess whether there is a proper balance or if some improvements are necessary to allow the market to function better – especially given the present context.

"In particular, synthetic transactions are often a misunderstood instrument that now need to be looked at with no bias from the past: they actually can play an essential role, as a tool both for risk management purposes (as they allow for freeing up regulatory and economic capital) and for supporting new lending growth and the real economy as a whole, since that released capital can be immediately redeployed. In our opinion, if we are able to drop past bias on the instrument, it could be an important and efficient way to let public resources flow directly to SMEs," he argues.

This is the way Intesa Sanpaolo, for one, views such transactions. "Therefore, we welcome the High Level Forum recommendation, which was very thorough in underlying some aspects that will need improvements – including simplifying the significant risk transfer assessment process, recalibrating capital charges applied to senior tranches, differentiating between disclosure requirements for private transactions and making the continuing interactions between originators and investors more flexible," states Giacalone.

High Level Forum

In the context of facilitating funding to SMEs via SRT, Thomas Wieser, chair of the High Level Forum, believes that a good starting point is to limit systematic ex ante risk assessment by Competent Authorities to complex transactions. "This – nearly by definition – would also enable SME-related products to be easily included in the securitisation framework, synthesised at comparatively low cost and thereby taken off the balance sheets of banks," he observes.

The SME lending gap from a supply perspective (HY2/2019)

Source: EIF: European Small Business Finance Outlook 2019

HIGH LEVEL FORUM REPORT

The aim of the High Level Forum on Capital Markets Union report was that it should not be general; rather, it should present a specific set of actionable recommendations. The report contains seven key recommendations regarding securitisation, which come under the section of the document entitled 'creating a vibrant and competitive business environment'.

The seven key recommendations comprise: improving the significant risk transfer assessment process by reducing the need for ex-ante reviews by regulators; recalibrating risk weights under the CRR; recalibrating capital charges under Solvency 2; promoting SME financing via securitisation through further alignment of data availability and underwriting standards; applying equivalent treatment to cash and synthetic securitisations; upgrading HQLA eligibility of STS securitisations and broadening the eligibility of current Level 2B securitisations; and differentiating between disclosure and due diligence requirements of public and private securitisations. The bulk of these recommendations had been under discussion by the industry for a number of years already.

Recalibration of capital charges, in particular, has been a long-standing request of the European securitisation market participants, given that the current supervisory formula results in punitive risk weightings for issuers. The industry is also hoping for improved LCR treatment for STS positions, which the HLF report states should be equal to that of covered bonds and be eligible for the HQLA bucket. Currently, only triple-A rated STS securitisations are eligible as Level 2B assets.

Another highlight in the HLF report is the invitation to policymakers to revisit public/private transparency requirements. Additionally, the report points to the significant need to free up bank balance sheets and address problem assets.

> "SYNTHETIC SECURITISATION OF CROSS-BORDER PORTFOLIOS WOULD ONE DAY BE A REAL GAME-CHANGER, BUT WOULD PRESUPPOSE A SIGNIFICANT CONVERGENCE OF LEGAL FRAMEWORKS"

He adds: "This would probably not generate significant interest among investors looking for long maturities – SME loans typically have a tenor of up to 10 years – so insurance interest would be lower than for other products. But other investor classes should very much welcome this."

Nevertheless, the presumption is that anything that frees up capital in banks will be beneficial to the economy, according to Wieser. He says that STS securitisation of non-SME products will be "just as welcome" and will translate into loan generation inter alia also for SMEs.

Indeed, there are various incentives and choices as to which assets banks use SRTs to free up capital for. "Capital is fungible and the capital banks are required to hold against SME loans is discounted – a bank needs to hold about 75% capital against an SME loan, versus 100% for a corporate loan, for instance – which means banks achieve a bigger bang for their buck by executing a corporate loan SRT. Once a bank has freed up capital by executing the SRT, they can use it to lend to whomever they want," explains Ian Bell, ceo of PCS.

He adds: "But it cuts both ways: a bank could issue an SME SRT and choose not to use the freed-up capital to lend to SMEs. What is important is that banks have a lending envelope."

One of Wieser's concerns, however, is that cross-border portfolios will continue be the exception. "Synthetic securitisation of cross-border portfolios would one day be a real game-changer, but would presuppose a significant convergence of legal frameworks, most importantly around non-bank insolvency. For large economies, this is not a huge issue, but it is a genuine issue for smaller markets," he says.

Recovery package

Regarding the capital markets recovery package announced in July, Richard Hopkin, md and head of fixed income at AFME, says the fact that the European Commission is planning to implement the EBA's work on STS for synthetics is positive – especially in the context of SME loans, which are very capital consumptive. "Policymakers are putting job growth at the heart of the Covid-19 economic recovery; SMEs are important drivers of job growth, so they are trying to facilitate more SME lending. The STS synthetics framework makes sense for banks lending to SMEs, as it will help them find new counterparties to share risk and thereby free up their capital for more lending. The 'quick fix' is a timely tool to help the economy recover from Covid stress."

Nevertheless, the key to increased capital relief trade volumes is whether originators are given preferential capital treatment – which, in theory, they should because they've transferred the risk. Some issuers are already executing SRTs, but the introduction of an STS synthetics label should incentivise more to enter the market.

Gandy says that preferential capital treatment under the STS synthetics regime is welcome and likely to have a beneficial effect on the margin – especially in light of the current wider pricing environment. "Policymaker support of the STS synthetics label sends a powerful message that the technology is OK if deals are executed properly. This, in turn, may encourage banks that had been reticent to enter the SRT market previously and ultimately facilitate lending to SMEs," he observes.

Richard Hopkin, AFME

He continues: "Certainly Santander is committed to SME lending across Europe and the STS synthetics regime will enable us to transfer more risk and therefore lend more than we otherwise would have. It enables us to do more of what we're already doing."

STS synthetics

Giacalone concurs that the STS label for synthetic securitisations could stimulate some originators to enter the market or to execute new transactions. However, he notes that for a positive effect on the economics of the transaction, it will be necessary to see if the achievable capital savings will be advantageous compared to the higher operating costs associated with obtaining the label.

"For cash securitisation, the STS label was driven primarily by investor protection," Hopkin observes. "But for synthetic securitisation, the STS label is primarily a prudential measure to provide banks with more options to manage regulatory capital, share risk with the capital markets and therefore lend more – especially to parts of the economy that consume lots of capital, like SMEs."

However, he agrees that to achieve optimum efficiency, the STS synthetics label must go hand-in-hand with a smooth and workable process for achieving SRT. In this regard, the next step is the publication of the EBA's report, which is due by January.

Giacalone indicates that in the current landscape, a smooth and workable SRT assessment process is now more than ever desirable by originators, to enable them to react quickly to extraordinary challenges and allocate resources strategically. He says that Intesa Sanpaolo's relationship with the supervisor has always been effective and transparent in the SRT space because the bank prefers to use straightforward features on its SRT deals.

"In general, we advocate for a shorter and lighter SRT assessment process for repeat/plain vanilla transactions to limit the operational burden and foster a healthy SRT business, in a time when the economy needs it the most," he adds.

EUROPEAN COMMISSION'S 'QUICK FIX'

The securitisation-related measures included in the European Commission's capital markets recovery package were welcomed for, among other things, removing the uncertainty regarding the EBA's reluctance to recommend recalibrating the CRR for STS synthetics.

The securitisation-related measures comprise a proposal to create a new category of STS synthetic securitisations and another to amend the retention requirements for non-performing loan securitisations. The first proposal follows the EBA's lead in defining STS synthetic securitisations, including the allowance of some utilisation of excess spread. The second would allow the 5% risk retention to be calculated on the discounted value of a pool of NPLs, rather than their nominal value, and for this retention to be held by the servicer/manager.

The proposals effectively extend the benefits of lower capital requirements to the senior tranche of STS synthetic securitisations and amends the capital treatment of NPL securitisations (the risk weight on an NPL ABS position will be subject to a floor of 100%, while the risk weight for senior tranches is set at 100%). Of note, the STS synthetic proposal contains grandfathering provisions, provided the new rules are met.

> "CERTAINLY SANTANDER IS COMMITTED TO SME LENDING ACROSS EUROPE AND THE STS SYNTHETICS REGIME WILL ENABLE US TO TRANSFER MORE RISK AND THEREFORE LEND MORE THAN WE OTHERWISE WOULD HAVE"

A European Commission review of the Securitisation Regulation is due by January 2022 and AFME is hopeful that some of the things that aren't included in the quick fixes – like Solvency 2, LCR and disclosure issues – will be addressed during this process. "Perhaps STS synthetics would have been part of this review, if Covid hadn't hastened the need to put the framework in place sooner. Policymakers understand the important role securitisation plays; they see how capital markets – including securitisation – have helped drive the post-financial crisis recovery in the US, for example," Hopkin concludes. ■

CHAPTER THREE: SEEKING CLARITY

The regulatory side of the equation may be falling into place in terms of facilitating SME significant risk transfer, but other challenges still need to be overcome for the market to reach its potential. While a small number of European SME SRT deals were discussed with investors in the second and third quarters of 2020, the vast majority of them are believed to be being discussed with the EIF – given that its mandate is to support the sector – until further clarity regarding SME performance emerges.

Constructing a stable SME SRT portfolio is challenging under the current circumstances. A number of sectors have been visibly impacted by the Covid-19 fallout – for example, hotels, restaurants and retail – which investors may want excluded from portfolios or contained from a size and rating quality perspective. However, the borrowers that are indirectly impacted by the pandemic are often harder to identify.

Payment holidays

Governmental stimulus programmes – introduced to help corporate, SME and retail borrowers manage their finances during the crisis – have further complicated the SRT investment landscape. While measures such as payment holidays have helped large-scale defaults to be avoided, they are temporary and the high take-up rate in some countries creates significant uncertainty as to whether these borrowers will eventually repay their loans.

"Are all of these borrowers truly distressed or are some simply taking advantage of the stimulus and preserving cash?" asks Kaikobad Kakalia, cio at Chorus Capital. "For most, it's probably the latter and they will restart payments when the scheme expires."

He continues: "However, if 20% of a portfolio references borrowers who have loans subject to moratoria, even if the investor assumes that 80% of these borrowers will be able to restart their payments, the remainder are a very significant proportion of the protected tranche. With no ability to undertake fundamental analysis on a non-disclosed and granular SME portfolio, the investor has limited ability to identify the borrowers who will default once the moratoria expire."

As such, investors may decide that all loans subject to moratoria are beyond their risk tolerance and therefore avoid any exposure to such borrowers. Smaller banks may struggle to select sufficiently sized portfolios if they are to remove such exposures, though larger banks will likely have a larger quantum of assets, allowing for further filtering by industry and borrower.

Multi-bank pools

In cases where smaller banks may struggle to build large enough portfolios, the EIF's Romanian deal from May could provide a template for a number of them to come together to execute an SRT transaction – although the logistics around portfolio construction and the allocation of capital relief between the banks would have to be worked out. The transaction features an uncapped guarantee under the SIUGI programme covering 60% of a €1.368bn portfolio of SME credit rights originated by Banca Comercial Romana, Banca Transilvania, BRD – Group Societe Generale, CEC Bank, ING Romania, ProCredit, Raiffeisen Bank Romania, Libra Internet Bank and UniCredit.

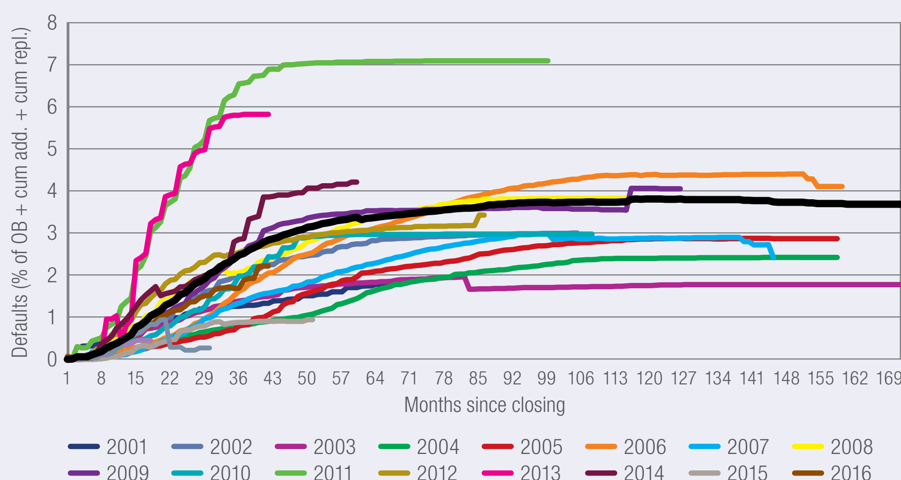
"The current context could provide impetus for these types of deals. The arranger's role would be particularly important in such a scenario in terms of driving the process forward and smoothing the dialogue within the group of originating banks, as well as between the banks and the investor," suggests Suzana Sava-Montanari, counsel at Latham & Watkins.

Market participants may simply need to wait until the moratoria expire and borrowers make a couple of payments, in order to see which borrowers are performing. Kakalia says that risk appetite remains for SME SRT deals, but that capital is seeking a higher return and to limit its risks.

Suzana Sava-Montanari, Latham & Watkins

"To the extent a bank has issued SRTs before and has portfolio flexibility, there is a good chance that the issuer and investor will find a way to make the SRT transaction work," he observes. "In the present circumstances, we prefer large corporate loan transactions as borrowers are typically disclosed. These borrowers are generally public companies and we are able to access and analyse their financial statements. This gives us greater certainty in our investment case."

SME loan and lease ABS – cumulative credit events or defaults on original balance (seasoning by vintage)



Source: EIF: European Small Business Finance Outlook 2019

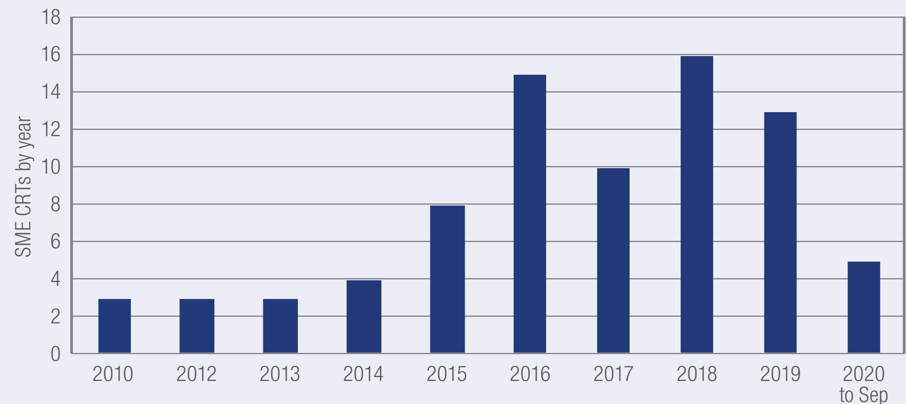
From the perspective of Intesa Sanpaolo, moratoria are positive for its customers in the Covid context, but at the same time could cause uncertainty for the market as well as for originators. Biagio Giacalone, head of the active credit portfolio steering unit at Intesa Sanpaolo, points to the difficulty of predicting or modelling what may happen once the payment suspension period ends and how the creditworthiness of companies will evolve.

"For transactions already in place, in our experience as originators, the implementation of the Covid moratorium has posed several challenges, such as an increased operational burden. On the investor side, there is an ongoing need to investigate the phenomenon, in order to understand how banks are handling the moratoria requests from clients," he notes.

Many of the EIF's legacy deals have been affected by payment holiday schemes, for instance. "In my view, the implementation of payment holidays was right and prevented many unnecessary defaults, but it was credit neutral for our transactions," notes Georgi Stoev, head of CEE and Northern European securitisation at the EIF. "Loans subject to payment holidays were not permitted in the majority of our deals, so we've had to amend the documentation to allow for them because originators asked us for support, in order to avoid early termination of the deals. For new deals, however, we recognise that an entity asking for a payment holiday is likely to be less creditworthy and this is acknowledged in our credit policies."

Integer Advisors managing partner Ganesh Rajendra questions if, to the extent payment moratoria continue, SRTs can be used to transfer the risk to the capital markets. "Theoretically at least, loans in forbearance may be well-suited to synthetic securitisations in so far as there is no reliance on asset cashflow to pay liability coupons, while the transaction can be structured whereby the investor takes ultimate risks of obligor non-payment. The roll rate from moratoria to default may be a quantifiable risk in many markets, though potentially not one that SRT investors are willing to stomach," he observes.

Georgi Stoev, EIF



Source: SCI Capital Relief Trades database

He continues: "At present, there is only a limited IFRS 9 accounting impact from extraordinary payment holidays, but further forbearance extensions may require staging of loss expectations. In many cases, in order to minimise ultimate default risks, banks may find it makes strategic sense to continue the payment holidays, irrespective of what the regulatory guidance is at that stage."

But any such decision will likely come at a cost to their balance sheets. As such, paying SRT investors to bear that risk may make sense.

Performance concerns

While the performance of the SME sector is currently being supported by emergency fiscal measures, Rajendra questions how the sector will perform over the next two to three years, given the temporary nature of this support. "The fallout is likely to be greater because SMEs are typically not as well-capitalised as larger-caps and are also more vulnerable to earnings and funding volatility. Unlike household credit that has benefited to a greater extent from direct 'helicopter' money, SMEs have more commonly been provided with loans to get them over the economic disruption. Fundamentally, this not only means that SME risk has merely been delayed, but potentially also magnified, given the incremental debt burdens post-Covid."

He continues: "Given the likelihood of an overhang of credit-impaired SME assets after Covid, the ability to lay-off such risks via SRTs is very valuable, of course. The question is if SME SRTs are even viable from a demand perspective at the eve of such a loss cycle."

Given the continuing economic uncertainty, Mascha Canio, head of credit & insurance linked investments at PGGM, anticipates more support to emerge for the SME sector – which she says complicates the SME SRT investment case even further. "As an investor, we can't create a case for SME default rates not being affected by the current crisis. At some point, some pricing equilibrium may be reached or a different pocket of demand tapped."

She adds: "Another solution may be for governments to guarantee SME loans, but what would that mean for bank capital? If the guarantees are close to 100%, banks aren't incentivised to transfer the risk."

RWA discount

PGGM's mandate is to invest in all kinds of credit risk, including SME SRT deals. However, some

> "THE IMPLEMENTATION OF PAYMENT HOLIDAYS WAS RIGHT AND PREVENTED MANY UNNECESSARY DEFAULTS, BUT IT WAS CREDIT NEUTRAL FOR OUR TRANSACTIONS"

aspects of the SME segment make risk-sharing transactions more challenging, according to Canio. She cites as an example the RWA discount for SMEs of close to 25%.

"Although such regulatory support means that the cost of capital is less for banks when executing an SME SRT, it doesn't necessarily help the investor, which still has to provide protection to the bank regardless of the discount. Many investors are interested in adding diversifying exposures – including SMEs – to their portfolios, but pricing remains a challenge," Canio observes.

Another challenge is the granularity of SME loans, which makes executing SRTs on such portfolios more cumbersome than for other asset classes, according to Rajendra. "It may be more challenging for protection buyers and sellers to reach common ground on SME pools, with the portfolio granularity often creating a bid/offer gap, both in terms of risk transparency as well as the clearing price of protection. The highest capital consuming SME exposures are normally unsecured loans, which may be a tough sell for investors."

He adds: "Investors need to get comfortable with the risk. With SME portfolios, they're buying into the backbone of the real economy via granular obligor pools that typically require a portfolio or actuarial rather than discrete, single-line approach. Arguably also there is a greater degree of vulnerability to bank credit selection, underwriting and servicing in the case of SME than in large cap SRTs."

Data availability

Canio notes that data availability is crucial in the risk-sharing space. For the limited number of SME deals PGGM has looked at, the firm was able to dig deep into the banks' historical data and come up with a number of questions, which led to the bank providing improved data.

"Generally, it would be helpful to see increased standardisation around the quality of the data. After STS, this is the next step for the securitisation market, but it is a significant challenge," Canio observes.

She continues: "It's crucial that the data allows one to compare apples to apples, with clean and clear definitions, and that it is subject to third-party verification. The latter aspect will help reliability."

Given that the traditional approach to analysing SME SRT portfolios – statistical analysis of historical data – is no longer appropriate in the current context, Sava-Montanari suggests that the lack of forward-looking data availability and the inherent difficulty in diligencing every name is one area that could be addressed in order to get private investors more comfortable with the sector. Indeed, she says that because efficient SRT relies on investors and banks establishing long-term partnerships, the technology is perhaps particularly suited to SME securitisation.

"There has to be a certain level of trust between originator and investor," she explains. "Whereas an investor can analyse each name in a corporate pool, since it's impossible to analyse each name in an SME pool, they have to trust what a bank tells them regarding its origination and loss containment policies. At the same time, banks could communicate more about loss mitigation and selection criteria, and be more flexible about building portfolios that work for both parties."

Giacalone says that in his firm's experience, establishing an SME SRT programme was a thorough learning process with investors – which improved over time, as the programme evolved over the following years. "To bridge this gap, it's important to set up a constant dialogue between the investor and the originator, in order to come up with a tailor-made transaction which can fulfill the objectives of both parties," he observes.

He adds: "The dialogue needs to be ongoing, as investors need to be up-to-date on the evolution of the portfolio through time. This is one of the reasons why originators in the synthetic securitisation space had been skeptical on ESMA reporting, which is tailored to traditional transactions, very rigid and, as such, not particularly useful when investors need flexibility."

Giacalone cites as an example the fact that, following the Covid-19 pandemic, investors are interested in having more information on payment holidays on a loan-by-loan basis. "That was new information not originally included in the dataset and which was added on an ongoing basis, following the explicit request by investors, given the flexibility we provide in reporting," he explains.

Sava-Montanari points out that while investors may naturally want higher compensation for investing in an SME portfolio, given that the asset class appears more vulnerable in the current environment, the transaction also needs to make sense for the bank from a cost of capital perspective. "Regulators are increasingly focusing on the efficiency of SRT deals. I doubt whether price alone will help offset this, so it might be a case of negotiating structural features to compensate – such as credit enhancement (with tranches attaching above 0%), higher risk retention, excess spread or shorter maturities."

Hybrid deals

Alternatively, hybrid transactions with mixed portfolios may be another way of increasing investor comfort with SME assets. Sava-Montanari cites Nordea's Matador transaction – which referenced a portfolio of corporate and SME loans – from December 2019 as an example. Under this scenario, a methodology could be created to accommodate different eligibility and replenishment criteria for each asset type, and a relative cap introduced to limit their concentration.

In the EIF's case, for example, it applies appropriate credit policies for the different constituent asset classes contained within a mixed pool and for secured versus unsecured exposures. The various credit analysis techniques it employs are similar to those used by rating agencies, according to Stoev.

"In most cases, we have mixed pools for size reasons; for example, if we can't achieve the desired funding or capital target with a homogeneous pool," he concludes. ■

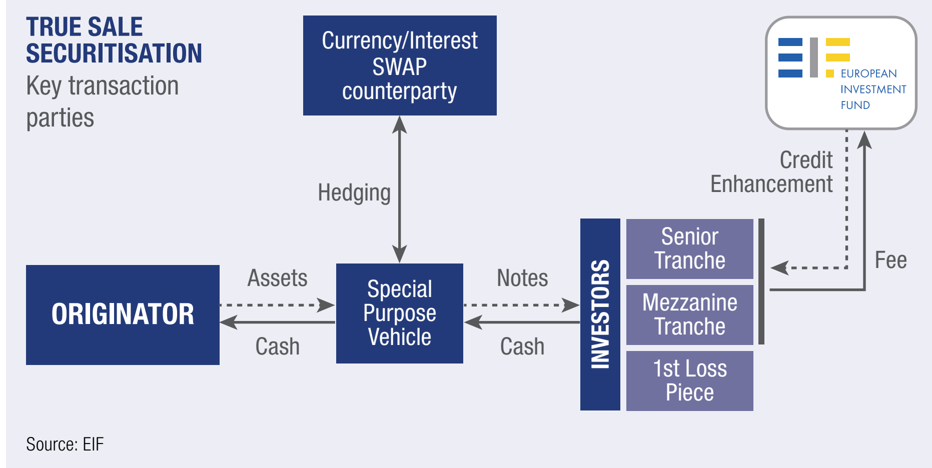
SME CRTs by jurisdiction

Source: SCI Capital Relief Trades database

CHAPTER FOUR: STEPPING UP

The EIF anticipates 2020 to be a record year in terms of its European SME synthetic securitisation activity, with easily double the volumes issued than under normal circumstances. Among the transactions closed by the organisation so far this year are three from first-time capital relief trade issuers.

Diagrammatic example of EIF's involvement in a SMESec transaction



Source: EIF

New lending

"Part of the EIF's mandate is to support the real economy when it needs it the most, so it's not surprising that we've stepped up our activity in light of the coronavirus crisis. We have redeployed resources earmarked for other projects into synthetics in order to stimulate new SME lending across Europe," confirms Georgi Stoev, head of CEE and Northern European securitisation at the EIF.

He adds: "SMEs are the backbone of the European real economy and any capacity we provide is redeployed to the SME sector as new lending. One aspect of SME SRT is clear: SME loans are versatile and liquid assets that lenders use for both capital and funding purposes, which – in turn – allows the asset class to price tighter than other asset classes that can't be deployed so easily."

Since the outbreak of the Covid-19 pandemic, the EIF has closed six synthetic SME financings (as of end-September), according to SCI data. Most recently, Volksbank completed its first significant risk transfer deal, which referenced a €700m Italian SME portfolio.

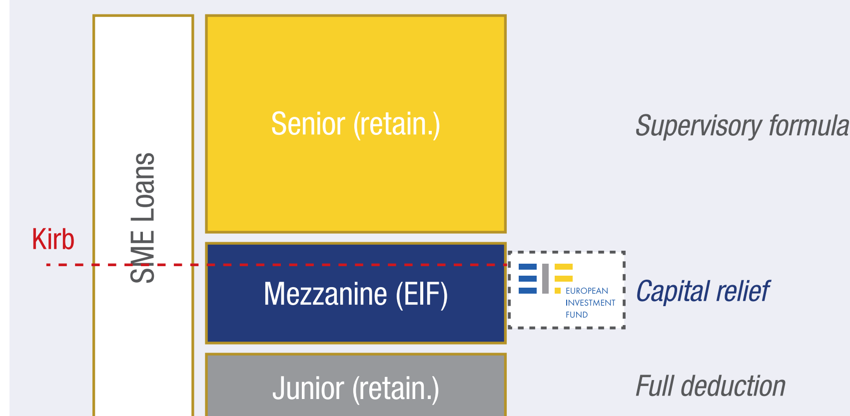
In July, the EIF closed an €87m mezzanine guarantee on a portfolio of Spanish SME and mid-caps with BBVA, as well as a PLN2bn Polish leasing receivables deal with Santander. Sabadell and Banca Agricola Popolare di Ragusa also completed their first SRTs the previous month, respectively securitising portfolios comprising €1.6bn of Spanish SME loans and €200m of Sicilian SME loans.

Finally, the EIF closed in May an unusual uncapped guarantee agreement with nine Romanian banks under the SIUGI programme, covering 60% of a €1.368bn portfolio of Romanian SME credit rights. Further transactions involving Romanian and Slovak lenders are in the pipeline.

Catalysing capital

Catalysing private capital is another of the EIF's aims and the organisation is in discussions with third-party investors regarding a framework for what it describes as "combination deals", whereby it guarantees the mezzanine tranche and private investors provide protection on the junior tranche. Potential alternatives could involve direct hedges provided by private investors

Features of an unfunded transaction



Source: EIF

Example for a potential tranching/ risk sharing

Tranche	Potential investor group
Senior	Private investors NPIs EIB EIF
Mezzanine	Private investors NPIs EIF EFSI or other public funds
Equity	Private investors Other public funds (e.g. ESIF)

Source: EIF

> “DATA SHOULDN’T BE A REASON NOT TO PURSUE AN SRT DEAL”

to EIF-guaranteed mezzanine tranches, but it remains unclear when such transactions could first emerge on the market, since the discussions are not finalised.

“With our expertise and overview of many markets, we can support investors in jurisdictions that are outside their core competence. The key to a well-functioning market is critical mass; in other words, creating a large and diversified pool of originators and investors that allows for specific mandates and bespoke appetites to be accommodated,” observes Stoev.

Gaps that could be filled as a result include the funding needs of start-ups, lenders to ESG-compliant loans and online lenders with small portfolios, as well as the investment requirements of pension funds and insurers for portfolios with longer tenors. “There is an interesting supply and demand overlap here that is gathering momentum,” Stoev remarks.

Transparency

He adds that transparency is crucial in terms of aligning the EIF’s interests with those of private investors. “While the EIF could retain a portion of an exposure on its balance sheet, in a successful framework, the ultimate risk taker (the private investor) should be party to exactly the same information as us.”

Stoev suggests that one of the main reasons why the SRT market is not as large as it could be is that it takes quarters, if not years, for banks that aren’t active in the space to gain the necessary confidence to engage in concrete discussions and put appropriate frameworks in place for their ALM and treasury functions. “Data shouldn’t be a reason not to pursue an SRT deal,” he says.

He concludes: “We request the same amount of data as a rating agency typically would in order to determine creditworthiness and neither standardised nor IRB lenders have ever had a problem in supplying it, in our experience. Certain large banking groups have legacy systems, which delays their ability to provide data, but ultimately they can produce what is required.” ■

EIF SUPPORT MEASURES

At the onset of the Covid-19 pandemic, the EIB Group mobilised up to €40bn to address the most urgent liquidity needs of SMEs. Key coronavirus support measures implemented by the group comprise: the Pan-European Guarantee Fund (EGF); enhanced terms for EU mandates, including the InnovFin, COSME, EaSI and CCS guarantees; and regional initiatives in cooperation with local governments, entrusting the EIF with targeted regional programmes to improve access to finance at the local level.

Jointly launched by EU Member States and the EIB Group, the EGF enables a number of equity, debt funds and guarantee products to be deployed in cooperation with selected financial intermediaries for the benefit of SMEs and mid-caps, and to scale up support to SMEs and others in the real economy by mobilising up to €200bn. The EIF launched a call for expression of interest to select financial intermediaries for the EGF on 31 August.

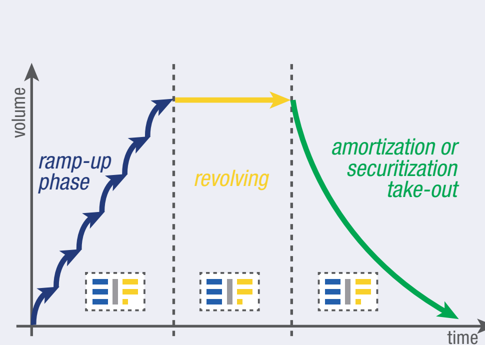
In the areas of credit guarantees and securitisation, the EIF cooperates with a wide range of financial intermediaries, including banks, leasing companies, guarantee funds, mutual guarantee institutions, promotional banks and other financial institutions that provide financing or financing guarantees to SMEs, such as debt funds.

Summary of initiatives

Initiative	Resources	Scope	Can be combined with:
Cash sec.	EIF’s own funds; EREM	Guaranteeing a cash investor which purchases a tranche of an SME-backed ABS or Covered Bond (internally rated BB or above)	EIB’s cash purchase.
Synthetic sec.	EIF’s own funds; EREM	Providing capital relief to an originator by guaranteeing a mezzanine tranche of an SME portfolio.	Third party risk-takers to transfer them the first-loss risk.
COSME sec.	COSME and EIF’s on funds	Guaranteeing/counter-guaranteeing the originator/guarantor of a portfolio to be built-up in order to provide capital relief.	N/A
SME Initiative	ESIF; H2020/COSME; EIF’s own funds; EIB funds	Multifaceted initiative to provide funding and/or capital relief to both standardised and IRB banks via synthetic or cash transactions.	Third party risk-takers to transfer them a portion of the first-loss risk.

Source: EIF

Features of a warehouse transaction



Warehouse Facilities

- EIF can **provide protection during the three phases** of a warehouse transaction, by providing a guarantee to the senior loan provider (typical advance rate: 15%-25%)
- EIF monitors the exposure during ramp-up and revolving phases via appropriate triggers
- If a **securitization take-out** is envisaged, EIF can provide a guarantee to the senior/mezzanine tranches
- Warehouse transactions work well with mid-market **asset finance providers**

Source: EIF

CHAPTER FIVE: CONCLUSION

The future seems bright for synthetic securitisation in Europe, given regulatory support for the technology and the growing needs of banks to manage credit risk efficiently. Indeed, the great hope of the industry is that significant risk transfer will help European banks to remain competitive in an increasingly globalised market.

> "WE EXPECT BANKS THAT ARE ALREADY USING SRT FOR THEIR LARGE CORPORATE LOAN BOOKS TO EXPAND THE UTILISATION OF THE TOOL TO THEIR OTHER LOAN BOOKS"

Growth opportunities

Mascha Canio, head of credit & insurance linked investments at PGGM, foresees there being plenty of growth opportunities for the risk-sharing market in the coming years – particularly in cases where banks are confronted with the need to manage credit risk. "Banks appreciate SRT as a hedging tool, especially for illiquid exposures. We expect banks that are already using SRT for their large corporate loan books to expand the utilisation of the tool to their other loan books. For example, nationally-focused banks typically have large SME portfolios and so a logical next step is for them to begin internal dialogues regarding SRT."

Canio suggests that while many participants avoided synthetic securitisation post-financial crisis, the support of the High Level Forum for the sector and the European Commission's fast-tracking of the STS synthetics framework will help them gain comfort with the technology. "The STS label is important for synthetics because it underlines the high quality of such a transaction. The framework doesn't exclude other securitisation to take place, but it encourages investors on the side-lines to enter the market," she explains.

Mascha Canio, PGGM

She continues: "There is a significant number of real money investors looking at the market, but which had been hesitant to invest. An STS label provides the basis from which they can formulate a persuasive mandate to invest in the sector."

Canio says that PGGM's recent co-investment agreement with Alecta illustrates this point. "Alecta is interested in standardisation and high-quality investments. But it's difficult for any fund to negotiate risk-sharing transactions from a zero starting point."

However, she notes that two criteria are essential for the STS synthetics framework, in order for it to align with PGGM's approach to risk-sharing. These are the originator having 20% skin-in-the-game, rather than the usual 5%, and there being no counterparty risk to the bank. In line with true sale securitisations, the cash should be safely invested in high quality securities.

Given that banks are well-capitalised and well-managed in terms of risk exposures, they are generally in a better position to deal with the initial shock of Covid than they were during the financial crisis. However, in the longer term, European banks will inevitably be impacted by credit losses and lower asset-based revenues, potentially coinciding with the need to rebuild capital buffers. Hence, Ganesh Rajendra, managing partner at Integer Advisors, is also bullish regarding SRT as a means of equity accretion and risk management – especially if the EBA STS synthetics recommendations are implemented.

He notes that European banks are typically disadvantaged in comparison to US and Asian banks. "Crudely put, US banks were encouraged to grow out of the last crisis in order to comply with new capital requirements, whereas European banks were guided into selling assets and de-risking business models to improve their capital adequacy. Covid-driven delays to Basel 4 implementation and the relaxation of capital buffers has given banks some respite; however, the European authorities have made it clear that these are temporary measures."

Sensible rules

As such, PCS ceo Ian Bell believes that the European market must move to a scenario where SRT isn't considered an exceptional event; rather, it is understood as part of normal day-to-day bank activity. "The lack of sensible rules isn't a trivial issue: the outcome is crucial to how the European banking market will look in 10 years' time. Capital relief trades will help European banks to remain competitive in an increasingly globalised market."

The approval process for SRT transactions has historically been complicated by the lack of clear and predictable rules. However, the ECB appears to be undergoing what one source describes as "a sea-change in flexibility and attitude towards approving SRTs".

The source concludes: "We now receive prompt and constructive feedback regarding transactions, and the ECB's instructions are as facilitative as possible. It still comes up with questions and challenges, but we'd rather this than deathly silence – it enables us to address any concerns during the structuring process, rather than after a deal has closed." ■