Maximum impact

In this second SCI CRT Case Study, **Stelios Papadopoulos** compares post-Covid SRT structuring from the perspective of both private and supranational investors. The impact of payment holidays on the capital relief trades market and the re-emergence of full deduction SRT transactions are examined.

Supranational and private capital relief trade structures have had to be adjusted following the coronavirus fallout to address the impact of payment holidays on deal performance. Indeed, both supranational and private investors have treated the issue with equal caution. However, full deduction significant risk transfer deals originated by standardised banks and solely backed by the European Investment Fund (EIF) have returned once again as a distinct supranational trend.

Payment holidays

Arguably the most salient development for capital relief trades following the coronavirus crisis has been the emergence of loan exposures subject to payment moratoria. Payment moratoria raise several concerns for the trades, chief among them being the challenge of estimating expected losses.

Surprising perhaps is the equal caution with which both supranational and private investors have viewed the feature. Robert Bradbury, head of structuring and advisory at StormHarbour, notes: "The EIF shares many of the same sensitivities as other private investors in risk transfer transactions and payment moratoria will be one of those issues. In contrast to most typical investors, however, they are solving for a different capital structure, as well as a range of their own parameters, given their specific mandate."

The same wariness is also visible in the case of the IFC. Xavier Jordan, cio at the IFC, explains: "It's not clear whether loans covered by forbearance schemes should be replenishable in SRT portfolios. The fundamental question is what should you consider 'regular' – a defined SRT term – in this case, particularly since a crisis like the one we are living through and regulatory actions in response to it were never really contemplated in the past. If you are a borrower availing yourself of a payment holiday then, at a 'gut' level, this indicates that you are more likely to have been adversely impacted by Covid-19."

He continues: "So, from the perspective of a protection-seller, it would be legitimately prudent to deem such assets as 'irregular' and exclude them from replenishment. Some banks, though, have said to us that doing so could amount to implicit support – although regulators have made it clear that payment holidays do not automatically count as so. Even if that is the case, they would still be arguably deemed irregular from our perspective. Future SRTs will have to draft precise language on this issue."

A landmark EBA guidance published in May explains why payment moratoria should not ▶

Jo Goulbourne Ranero, Allen & Overy

automatically count as implicit support *(SCI 1 May)*, although analysis will still be required. Jo Goulbourne Ranero, consultant at Allen & Overy, notes: "Assets that are already affected by payment moratoria at closing can be excluded using eligibility criteria. We have seen differing approaches in relation to assets that become subject to payment moratoria post-closing. It is worth noting that the EBA guidance around implicit support, in this context, indicates that certain actions are not automatically regarded as implicit support. It doesn't mean that they cannot amount to implicit support and analysis is needed."

She adds: "For example, it may make sense to an originator who does not itself recognise impairment to refrain from calling a credit event, where entitled to do so. But is that decision necessarily in their interest, if the maturity of the protection is not extended to match the extended maturity of the asset? For traditional deals, we gather that the ECB is focused on market pricing and prior notification in relation to proposed moratorium-related repurchases."

Some transactions, such as BBVA's and Santander's post-Covid full-stack SRTs, have adhered to the IFC's strict approach and articulated strict eligibility criteria that prohibit the inclusion of payment moratoria at closing or over the length of the replenishment period *(SCI 24 July)*; other deals have ditched replenishment altogether and opted instead for a static pool *(SCI 3 July)*.

Nevertheless, this may not always be possible, and this applies to both supranational and private transactions. Hence, other factors will have to come into play.

According to Giovanni Inglisa, structured finance manager at the EIF: "If you are working with a small regional bank, you can't be too picky during the portfolio selection process, but you have to be careful about the type of payment holidays you get exposed to. We do not like payment holidays that are a capitalisation of interest or where postponed interest is added to capital."

Further considerations for the EIF is the length of the payment moratorium, with 12 months pointing to a weaker borrower profile, compared to three months, for instance. Overall, Inglisa states that payment moratoria account for a small percentage of EIF portfolios and he does not expect the take-up rates for SMEs to increase.

Similarly, Boudewijn Dierick, md and head of ABS structuring at BNP Paribas, comments: "In some UK portfolios, payment moratoria might top 15% – as opposed to below 5% for most European pools – but, overall, we have observed a peak in take-up rates. If there is more, you might add a liquidity reserve for whatever excess percentage of the pool is subject to moratoria. Replenishments could also stop if defaults go up, along with other stricter eligibility criteria. Investors have also inquired about shorter replenishment periods, but for rated deals, that could be an issue since you get penalised by the rating agency irrespective of their length."

> "ASSETS THAT ARE ALREADY AFFECTED BY PAYMENT MORATORIA AT CLOSING CAN BE EXCLUDED USING ELIGIBILITY CRITERIA"

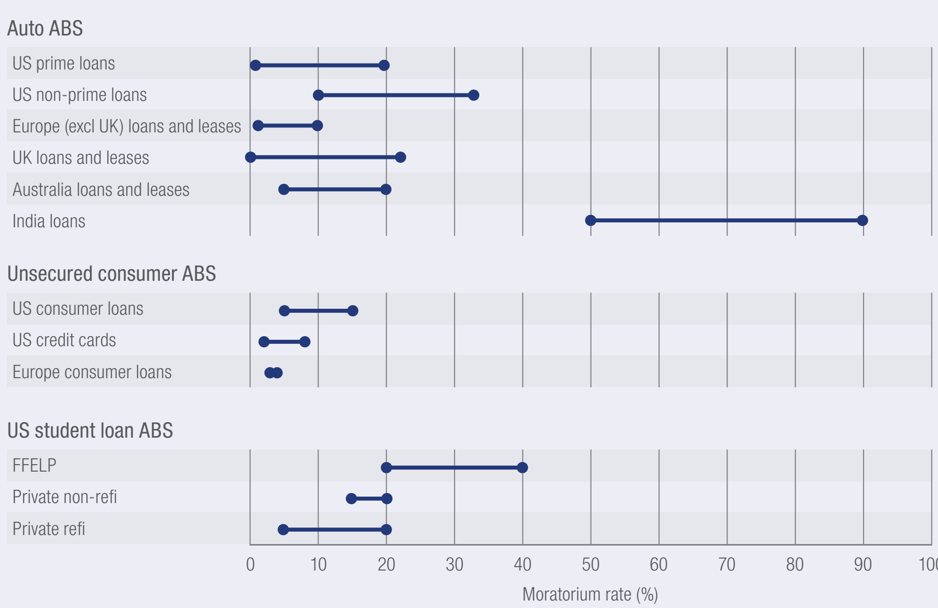
Another question mark with moratoria is their impact on excess spread migrations. On the one hand, payment holidays are not automatically classified as arrears or in default, so this should not alter the amount of available excess spread.

Giuliano Giovannetti, md at Granular Investments, notes: "In a synthetic securitisation, the senior tranche is retained, so – in the absence of a market price – synthetic excess spread is defined through a formula, often based on the amount of performing loans. Since payment holidays are not automatically classified as arrears or defaults, their presence shouldn't alter the amount of available excess spread."

Yet, on the other hand, moratoria imply a level of uncertainty, since any associated losses that would have otherwise crystallised will simply not go through the excess spread structure for a time. Consequently, "once payment moratoria come to an end and depending on the specifics of the structure, there may be something of a 'cliff effect', whereby excess spread is significantly impacted," cautions Bradbury.

Nevertheless, any impact will depend on the length of any delays. "Payment moratoria may postpone defaults by one or two quarters, so – depending on whether the format is trapped or 'use it or lose it' – there may be an impact. Since the delay is not long enough, there should not be

Exhibit 1: Moratorium rates – July 2020



Source: Moody's

any major impact," says Pablo Sanchez Gonzalez, structured finance manager at the EIF.

Full deduction SRTs

Payment moratoria has been a major thread running through both supranational and private capital relief transactions. However, full deduction SRTs originated by standardised banks and solely backed by the EIF have re-emerged as a distinct supranational trend.

One of the methods in the CRR for obtaining capital relief is the full deduction method, which states that if banks recognise a 1250% risk weight for all their retained tranches, they can derecognise their assets without having to satisfy the SRT tests. Effectively, by transferring all tranches except a retained junior tranche that is fully deducted, there is no need to undergo a time-consuming SRT process, since, by definition, the originator has transferred close to the full capital stack.

Ranero remarks: "It's a general principle in the CRR that the risk associated with an exposure is adequately covered if it's subject to CET1 deduction or a 1250% risk weight. The EBA's 2017 SRT discussion paper indicates though that the documentary and structural SRT requirements in article 243/244 (5) still need to be satisfied, but it wouldn't involve any regulatory submission."

Santander became the first lender to complete a post-Covid full deduction SRT for its Polish subsidiary *(SCI 9 July)* – although full deduction deals are not a novelty for the market, as StormHarbour's Polish leasing trade from last year demonstrates *(SCI 9 January)*. Nevertheless, they are rare and tend to be executed between the EIF and standardised banks.

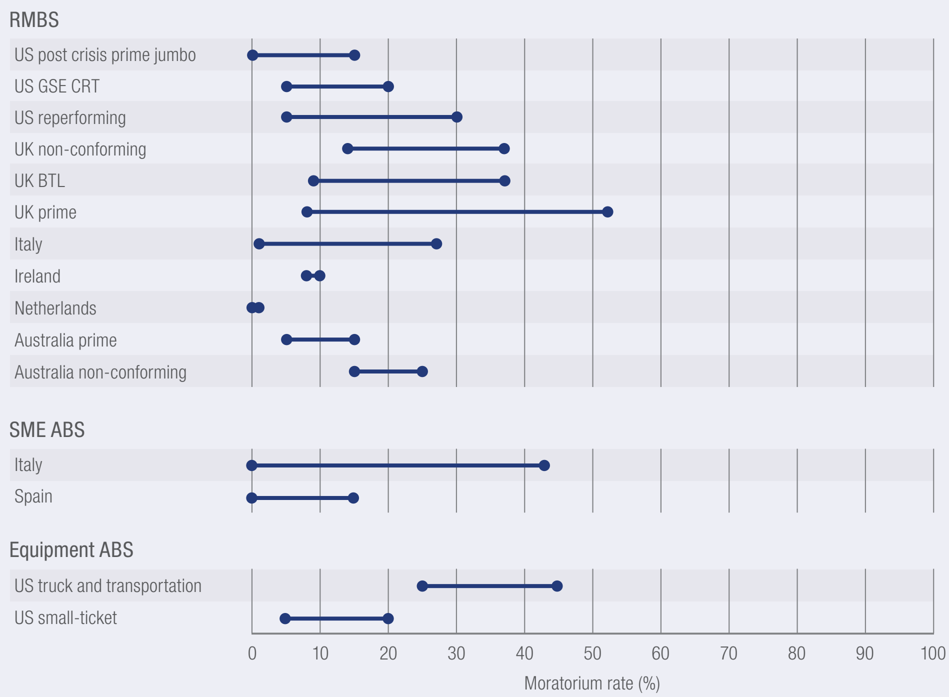
Dennis Heuer, partner at White & Case, states: "They won't work for everyone. First, it is obviously expensive to sell close to the full capital stack, so they only work better with excess spread and EIF participation."

He continues: "From a capital efficiency perspective, it is better to retain the senior tranche because it does not have a high-risk weight and banks can use it as ECB collateral. The senior tranche should be looked at as vendor financing because economically you create leverage, while if you transfer everything, there is the cost of the coupon payments. In the end, it really depends on what goals you have."

Any decision to sell or retain the senior tranche will depend on market rates, capacity and the bank's cost of capital. The calculation of the latter considers the bank's CET1 ratio, its pre-tax cost of capital and the 15% senior capital charge, as stipulated by the SEC-IRBA and the SEC-SA.

If the bank can find protection for the senior tranche that is consistent with its cost of capital, then selling makes sense; otherwise, it will have to retain the senior tranche. The capital charge for the latter drops from 15% to 0% if guaranteed by the EIF.

Exhibit 2: Moratorium rates – July 2020



Source: Moody's

However, several other factors will weigh on the decision, such as the actual CET1 ratio, the overall capacity of the EIF or the market to absorb senior tranches, the simplicity of full deduction, the risk and appetite of the bank, as well as available opportunities for redeploying freed-up capital.

Yet tapping the market for the senior tranche will typically prove to be prohibitive. In fact, a market for funded synthetic triple-A tranches at a price that is equal to or less than the cost of capital does not exist.

Giovannetti explains: "Due to the low RWA of the senior, an unfunded solution from private re/insurers would not work due to their counterparty risk weight. So, the full deduction option for synthetics will more likely suit the EIF and similar institutions."

He adds: "Synthetic deals are also often proportionally rather than sequentially amortising, which may significantly increase the WAL of the senior, compared to a true sale. If the synthetic deal was made sequential to accommodate the senior tranche investor, then the price of the mezzanine or junior will likely go up."

Another constraint is the more punitive SEC-SA formula and the associated cost considerations, hence limiting full deduction issuance to standardised banks. IRB portfolios already have regulator-approved models in place that allow an issuer to assign PDs and LGDs for each loan.

By contrast, standardised portfolios do not have models approved or individual PD and LGD calculations assigned. Hence, it is harder to estimate expected loss and therefore standardised banks must use the SEC-ERBA or SEC-SA formula.

The SEC-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 so the regulator can be comfortable with the loss variability. The challenge is whether the thicker tranches 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 therefore need to offer a higher yield to investors.

Bradbury notes: "Near full capital stack transactions take best advantage of the EIF's 0% risk weight by covering the largest volume in the most cost-efficient way. The market environment is also particularly relevant for such transactions, since a 'standard' market transaction in the form of a full capital stack transaction is less likely to give an attractive cost of capital at the moment, as well as helping originators which may not be able to access the market for various reasons."

Covid-19 impact

One question is whether Covid-19 could lead to more full deduction issuance. At first glance, this does appear to be true for this year, given that some transactions that were initially intended as risk-sharing SRTs – where private investors buy the first loss tranche and a supranational and/or insurers acquire the mezzanine pieces – have shifted to full deduction, following a post-Covid retrenching of private investors from the junior segment of the standardised bank market.

Some issuers concur that there will be higher full deduction issuance after the fallout, but they expect it to be restricted to higher expected loss portfolios, such as consumer loans. "By running excess spread through the entire waterfall, investor exposure to the potential volatility caused by potentially higher Covid-affected losses is reduced. The cost of protection will be therefore lower, since investors will not be demanding a higher coupon for that protection," says Steve Gandy, md and head of private debt mobilisation, notes and structuring at Santander Corporate and Investment Banking.

An additional advantage of full deduction deals is that banks do not have to hold capital against excess spread. According to Philipp Voelk, senior manager at PwC: "Quantifying excess spread, if you have a balance sheet model, can be hard since excess spread discounts future or-lose-it excess spread position, since it is future income and it's not yet accounted for anywhere. Additionally, you reduce the efficiency of a deal without really achieving anything material from a supervisory perspective, other than just chipping a bit from the RWAs of the junior tranche."

However, the full deduction option does not offer a free pass. Voelk explains: "Excess spread could be part of a junior tranche that puts losses in a black hole, given that it's not accounted as a retained tranche, but supervisors won't accept this. If banks retain excess spread cashflows, along with a retained tranche, there's still room for regulators to assess whether the quantum of excess spread is higher compared to the expected loss of the portfolio."

Hence, regulators could ask for a revaluation of the tranches – although it would be "odd to add further excess spread protection when an investor buys 95% of the portfolio; if you buy so much of the portfolio, why ask for additional protection," says Voelk.

"QUANTIFYING EXCESS SPREAD... CAN BE HARD SINCE EXCESS SPREAD DISCOUNTS FUTURE CASHFLOWS"

cashflows. The benefit of the full deduction method is that you don't have to account for future defaults and losses, so there is no need to hold capital against an excess spread position."

He continues: "However, you suffer interest losses, so maybe lenders should hold capital against it or payments that haven't been received by interest could be offset by principal cashflows. But there's no regulatory provision for this. We will have to wait for the EBA's final SRT report for some guidance."

Likewise, Giovannetti remarks: "There's no point setting capital charges against a thin use-it-

Philipp Voelk, PwC

Until the EBA offers more clarity through its final SRT report, banks are adhering to the supervisor's guidance by capping excess spread in a synthetic securitisation at the expected loss of the portfolio. "Excess spread in synthetic securitisations is rather conceptual, since the cost of the protection is not directly linked to portfolio cashflows. Due to this, banks may apply a cap on the excess spread and/or deduct the excess spread balance in the same way as for a retained first loss tranche," says Pascale Olivie, director, asset-backed products at Societe Generale.

Full-stack true sale SRTs, by contrast, have no limits on excess spread, given that the originator sells the whole portfolio. The logic here is that if the bank sells the whole pool, it achieves market pricing and there is, therefore, no situation where excess spread could be artificially inflated to support the junior tranches.

Indeed, regulators currently demand that banks sell 80% of each note, while the remainder can be guaranteed by a supranational investor. However, the EIF has raised questions about the necessity of this practice.

"We are lobbying against this, since we believe that you can equally achieve market pricing by selling 50% of each note, for instance, and we can

Georgi Stoev, EIF

then guarantee the other half. Doing this would allow us to expand further financing to the real economy," states Gonzalez.

Overall, the benefits of full deduction SRTs are clear, but further future issuance will likely remain sporadic. Voelk comments: "Full deduction effectively covers all possible losses and you can use it if you have a lot of equity, since it's the maximum impact you can have on capital. Therefore, originator appetite for full deduction transactions will usually be highest when capital is abundant during an economic boom and internal risk management specialists are scarce. However, as Covid-19 boosts expected losses and renders capital scarce, it will be the other way around – and even more true if you consider how difficult it is for European banks to raise equity now."

Georgi Stoev, head of CEE and Northern European Securitisation at the EIF, notes: "Most banks still notify regulators, even if they use full deduction deals, and they are likely to remain restricted to standardised banks because of the disadvantages of SEC-SA versus SEC-IRBA. At the same time, for some banks, selling a thin junior tranche can be expensive because it's extremely leveraged, so retaining it might be a better option."

Looking ahead, he concludes: "Covid is unlikely to alter the behaviour of the advanced IRB banks and push them to switch to full deduction deals, as opposed to mezzanine only. IRB banks will likely aim for thicker mezzanine tranches to adjust for the increased RWAs of the underlying portfolio following the crisis. As such, banks would still be able to have low RWAs for the senior tranche, even if the portfolio suddenly migrates into strong negative territory."

*SCI's CRT Case Studies are published on a quarterly basis and offer an in-depth examination of broader market phenomena through a single or comparative investigation of a given topic. The aim is to bring the benefits of the case study approach to reporting on the capital relief trades market. For further information and subscription details, email **jm@structuredcreditinvestor.com** (new subscribers) or **ta@structuredcreditinvestor.com** (existing customers).*