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Synthetic securitisation makes a comeback

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Securitisation was almost deemed to be a bad word at the end of the global financial crisis. Following the Bear Stearns demise, Lehman collapse and the credit crunch, a number of investors discovered that an alphabet soup of credit products were at the onset of the crisis. ABCP, CPDO, CDO and CDO-square to name only a few were splashed across the news as the main culprits for the worst financial crisis post World War II. Aside from plain vanilla structured credit, the most complex structures disappeared for a while and investors focused on simpler strategies. 2016, however, saw a robust return of bank's balance sheet synthetic securitisation deals and 2017 is very likely to see even more of those trades. Bloomberg reported recently that Nordea and Lloyds Banking Group have both used these types of transactions as a way to reduce their credit risk exposure. Last year, Dutch pension fund PGGM also disclosed a EUR 2.3Bn transaction with the Spanish lender Banco Santander. What are exactly these deals and do they pose a threat to the system?

Synthetic securitisation, also called capital relief bonds or risk sharing transactions, involve a bank, a book of performing loans, and an investor willing to sell insurance. The bank buys credit protection, through the use of credit derivatives technology, on a portfolio of loans from an investor, usually being a sophisticated pension fund, specialty credit investor or a credit hedge fund. The bank retains ownership of the asset on its balance sheet but the credit risk is being transferred to the seller of insurance. The rationale for the bank to enter into such a transaction is the capital relief factor on its balance sheet as well as credit risk hedging. Because the credit risk is being transferred to another entity, the capital treatment of the loans remaining on the balance sheet of the bank is being reduced, thereby positively impacting the RWA ratio of the bank.

The term synthetic securitisation must be understood in opposition of a true sale transaction. In a true sale transaction, the bank and the buyer agree on a portfolio of loans that is being effectively transferred to the buyer in exchange of funding. The rationale for a true sale transaction is funding. In the case of a synthetic transaction, the rationale is credit risk management. The bank receives no payment when the transaction is being closed but only if a credit event happens, i.e. a loss in the credit portfolio. Typical transactions, being true sale or synthetic, involve corporate exposure, trade finance, lending to small and medium enterprises. Mortgages are usually not a part of those deals.

The resurgence of such transactions is a clear illustration of the dynamics of supply and demand. On one side, banks are being pushed by the regulator to restructure their balance sheet in the context of Basel III and to increase their tier I ratios. Even if Basel IV seems to be pushed back for now, the capital treatment of loans remains expensive and banks are being incentivised to find ways to reduce this exposure.

Meanwhile, a number of banks continue to be saddled with non-core exposure or non-performing loans, which are expensive to carry. The sale of this exposure on the secondary market is feasible, but transactions are lengthy and rather complex. In addition, investors in European non-performing loans are being pickier as the market has matured. On the demand side, sophisticated investors such as credit hedge funds, continue to chase yield and a number of funds have access to long term capital enabling them to participate in those transactions. Last year, a few funds were launched with the sole purpose of investing in risk-sharing transaction, while other managers are allocating a portion of their specialty credit books to synthetic securitisation.

Investors should keep in mind that synthetic securitisation is not a way to reduce the risk in the system, it is simply a transfer of risk from a bank to a non-bank entity. As the transactions are private, it can be difficult for the regulator to track which entity is exposed to what particular credit risk, which has led to its involvement in this market.

The European Commission has taken a strong view on true sale securitisation. It recognised that securitisation, if of high quality and structured under a commonly accepted framework, can add value to the real economy. It has therefore issued a criteria to make securitisations simple, transparent and standardised (STS criteria). The simplicity rule implies that the assets being transferred are not encumbered, no loss has occurred and the loans have been originated during normal course of business. The transparency rule assumes that the bank originating the transaction must be able to provide historical data on losses to investors while the standardisation rule states that interest rate and currency risks must be mitigated and the mitigation methodology disclosed, as well as a number of other conditions. If a true sale transaction is deemed STS, the bank is allowed a preferential regulatory treatment.

The European Commission has not yet fully endorsed STS criteria for synthetic transactions; however, in a recent report, the European Banking Authority recommended that synthetic securitisations, under a specific list of constraints, should be able to benefit from an equivalent treatment to their true-sale counterparts. The discussion is still ongoing but most participants are optimistic that this risk-sharing technology will gain official recognition.

The adoption of a harmonised standard for synthetic deals can only been seen as positive for European banks and investors. From the bank’s perspective, working under a common framework would allow them to execute transaction more efficiently while investors will be in a better position when performing due diligence as the structuring details will most likely converge. Finally, there is today an emerging secondary market that can benefit from the harmonisation of deals.

When adequately structured and if correctly monitored within a commonly accepted framework, synthetic securitisation or risk-sharing transactions are a positive tool for the banking sector. They allow banks to focus on their core lending business while transferring unwanted credit risk to institutional investors. Similar to the sale of non-core exposure, risk-sharing is a way for banks to strengthen their balance sheet and recycle capital in key businesses, hence increasing the likelihood of adding value to the real economy and potentially boosting European growth.

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