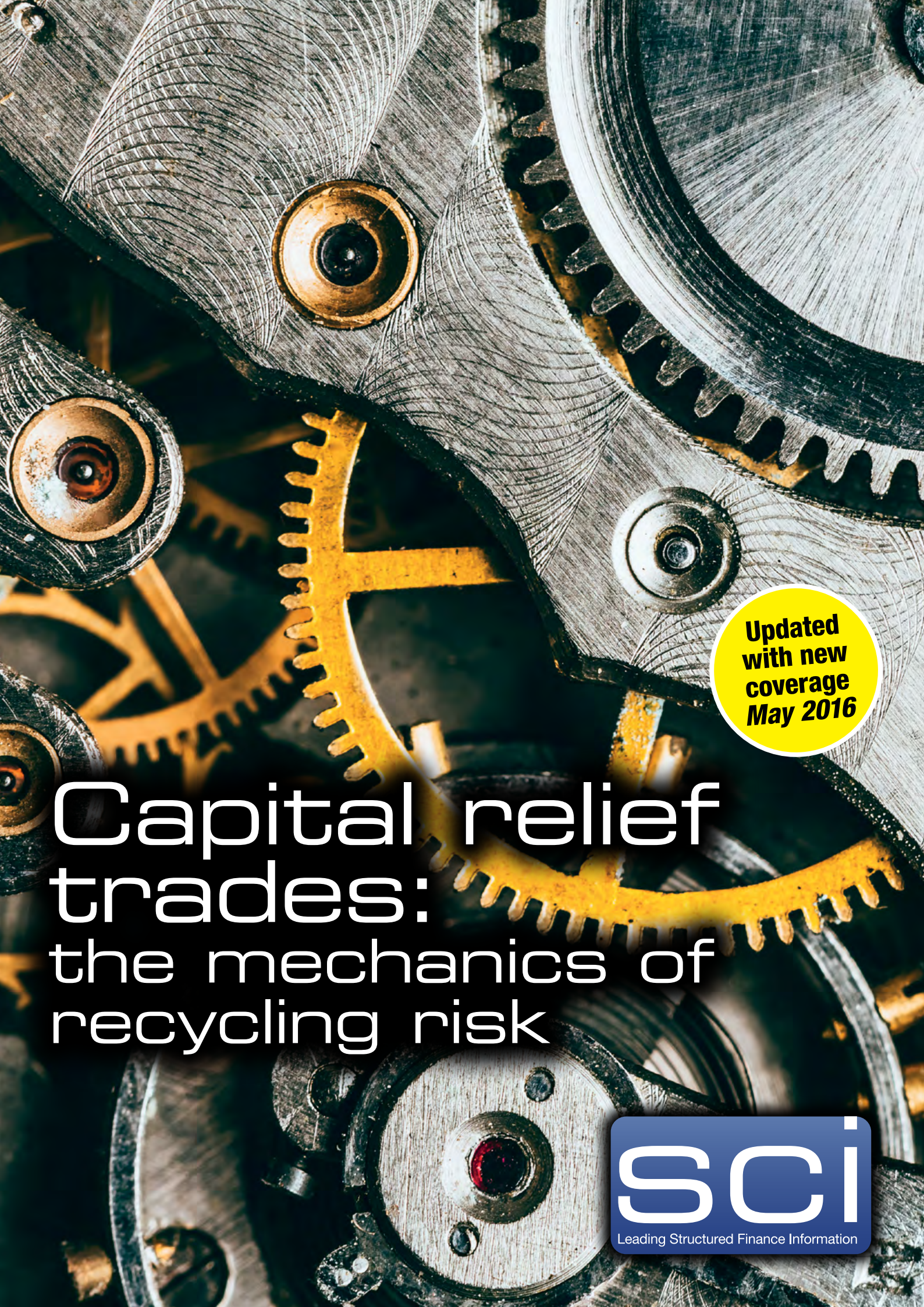

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Capital relief trades: the mechanics of recycling risk

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Capital relief trades: the mechanics of recycling risk

Contents

**This report was written by freelance journalist Rachael Horsewood and edited by SCI editor Corinne Smith*

Optimisation strategy

The implementation of Basel 3 requirements is forcing banks to scrutinise their risk weighted assets and pursue balance sheet optimisation strategies via regulatory capital relief trades. This SCI research report* examines the evolution and structuring of these risk transfer transactions, the main players in the market, current opportunities and challenges, as well as how regulatory developments are shaping the sector.

Executive summary

Capital relief trades (CRTs) are typically defined as synthetic securitisations through which banks transfer the risk of a reference pool of credit exposures to non-bank investors. The transfer can occur though a credit default swap or a financial guarantee with a special purpose vehicle, or it can be embedded in a credit-linked note that the bank issues. The credit exposures should arise naturally in the course of a bank's business, according to Christofferson, Robb & Company chief executive officer Richard Robb, and can be on-balance sheet or off-balance sheet assets.

CRTs release capital by reducing the risk weight of a bank's assets. The Core Tier 1 (or Common Equity Tier 1) ratio increases after the trade because the denominator decreases.

Synthetic securitisation is highly effective as a risk transfer mechanism due to the mutual benefit to both originators and investors. Investors are able to access credit risks that are more interesting and diversified, while originating banks can reduce their capital requirements and retain ownership of the underlying exposures.

The CRT market has bifurcated over the past decade between syndicated – where the issuer seeks wide distribution and a reasonably liquid secondary market – and bilateral transactions. While banks disclose the broad terms of the latter deals on Pillar Three reports, they can share information with the single investor on a scale that would not be possible in a public securitisation. A bank's private information, which might benefit competitors, can remain private.

To date almost 20 banks around the world have issued CRTs to help optimise their balance sheets, with the first ones debuting almost two decades ago. 2015 has been a pivotal year, however, as banks implement new Basel 3 requirements and some landmark deals in new jurisdictions and assets come to fruition. Over 40 pools of credit are currently being contemplated across Europe.

> "Synthetic securitisation is highly effective as a risk transfer mechanism due to the mutual benefit to both originators and investors"

CRTs make most sense when a bank has a large, diverse portfolio and has determined that the regulatory capital burden on these assets far exceeds the economic risks. The economics of the transaction depend on a combination of the cost of the market hedge and how effectively the investor's capital contribution is at releasing the regulatory capital.

Larger originating banks have credit portfolio management (CPM) teams driving the process for creating and completing CRTs – from identifying the assets to fine-tuning capital ratios and freeing up capital for specific businesses. The process is not universal, nor is it fast-moving, and – regardless of the starting point – various departments within the bank will influence the direction; for example, accounting, tax, risk and treasury.

One of the biggest challenges, particularly for newcomers, is regulatory approval. Although most central banks have made regulations for capital relief trades clearer and more readily available in recent years, uncertainty still looms in some markets and across borders.

Around 10 credit investment managers dominate activity in the CRT market. Having the extensive credit and structuring skills needed to build a portfolio and negotiate full documentation over several months are the main barriers to entry.

> "CRTs make most sense when a bank has a large, diverse portfolio and has determined that the regulatory capital burden on these assets far exceeds the economic risks"

Investment managers maintain strong ties with potential originators, considering the time and due diligence involved in completing CRTs. Equally, banks target specific risks in these deals, necessitating price negotiation and bespoke structuring.

Returns are peaking at around 10% today. While they can be a lot more attractive compared to the underlying economic risk, yields are not as high as they were a few years ago when some reached 15%.

Of all the layers of regulation affecting securitisation, the European Commission's Capital Markets Union proposals for reviving Europe's securitisation market sparked the most talk among players in the capital relief space this year. Mainly because, under the framework for simple, transparent and standardised (STS) securitisation, synthetic balance sheet securitisations remain ineligible for the high quality status. If synthetics were classified as STS, lower risk weights on super-senior tranches could attract new real money investors to the sector, as well as offset the cost impact of new higher risk weights that are being introduced in 2018.

The treatment of junior mezzanine tranches, the incorrect use of tranche maturity as a risk driver, the calibration of the SEC-IRBA and some aspects of the limits placed on the use of formulae-based approaches are also problematic for the CRT sector under Basel 3. One solution would be for Europe to alter the position in the hierarchy of approaches of the SEC-ERBA and the SEC-SA.

Looking ahead, the convergence of banking supervision in Europe and the European Banking Authority's forthcoming 'European Single Rulebook' is expected to open up more countries to CRTs. Although synthetic securitisations are likely to remain the norm, whole loan cash securitisations and portfolio acquisitions are expected to gain traction as balance sheet optimisation strategies in the future.

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