Record breakers?

The coronavirus crisis has laid out the conditions for a surge in capital relief trade volumes this year, following a challenging 2020. **Stelios Papadopoulos** reports.

The capital relief trades market is set to break issuance records in 2021 after a challenging 2020, as banks seek ways to improve their return on equity and following pent-up issuance from last year. Indeed, somewhat paradoxically, the coronavirus crisis has laid out the conditions for a surge in risk transfer volumes this year.

According to SCI data, overall tranche notional issuance reached €10.7bn in 2020, surpassing the 2019 record (€9.2bn). However, EIF transactions accounted for close to a third of 2020 volumes versus approximately 3% for 2019. Furthermore, overall private CRT issuance dropped from €8.9bn to €7.5bn between the two periods.

Nevertheless, given the severity of last year's crisis, the market seems to have weathered the storm well. Government and central bank support, static pools or tough replenishment criteria and the focus on large corporate exposures among other factors kept the ball rolling. Large corporate exposures as opposed to SMEs benefit from access to capital markets, diversified balance sheets and greater disclosure that allows investors to form a view on the underlying risk.

In fact, the coronavirus crisis has laid out the conditions for a surge in volume this year. First, as with other alternative asset classes, CRT trades offer yield along with high quality collateral after another round of rate cuts and quantitative easing. More saliently though, it is arguably the most significant tool that banks have for boosting their return on equity in a low rate environment.

Stuart Graham, partner at Autonomous Research, states: "EU banks have low ROEs and the bulk of the credit RWAs are allocated to low ROE corporate and SME credits. This is where SRT comes in because you can use it to free up capital and boost ROEs."

He continues: "Now as opposed to 2009, there aren't any black holes in bank balance sheets, but investors don't believe they can make an adequate return in a negative rate environment. You can try to pass on those negative rates to consumers or reduce your costs, although that is always problematic. SRTs, on the other hand, are much more cost effective."

Crucially, SRTs free up capital for share buybacks. Graham notes: "Share buybacks will become more important over the next two years, given the dearth of investment opportunities in a low rate world, since it doesn't offer many opportunities to deploy capital profitably thanks to 10% equity investor thresholds. Dividend payments will be limited to circa 2% yields, so right now there is not much of an incentive to do an SRT to free up capital for buybacks. Consequently, it's after 1 October that things begin to get interesting."

In December 2020, the ECB asked all banks to consider not distributing any dividends or execute share buy-backs or to limit such distributions until 30 September 2021, given persisting uncertainties over the economic impact of the Covid-19 pandemic. In particular, the central bank stated that it expected banks to keep dividends and share buy-backs below 15% of cumulated profit for 2019-2020 and not higher than 20bp of the CET1 ratio.

Additionally, although regulators have talked about a return to normal on dividends and buybacks from 1 October, what this means precisely is unclear. Still, Autonomous believes that it is unlikely that it will be anything other than a viable medium-term capital plan where CRTs play an important role. ▶

Second, deals that were planned for 2020 have been postponed for 2021. Kaelyn Abrell, partner and portfolio manager at Arrowmark Partners, notes: "The uncertainty surrounding the pandemic last year rendered it more expensive to issue in 2020, since investors applied more conservative underwriting assumptions and sought to remove Covid-sensitive sectors or required additional compensation to offset the risk. As a result, transactions that were planned for 2020 have now been pushed to 2021."

Kaelyn Abrell, Arrowmark Partners

Another issuance driver unrelated to Covid-19 is scheduled call dates. Another investor comments: "We expect a lot of deal refinancing this year. As portfolios remain at the same size throughout the replenishment period, then RWAs remain the same as well. So once replenishment comes to an end, you have to replace the trades to get the same level of capital relief. Some banks have made a practice of calling deals to be predictable, yet other banks do not follow that practice, which does affect the pricing."

However, questions remain over several issues, most notably payment holidays, IFRS 9 provisioning and other regulatory headwinds. 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.

> "INVESTORS CONTINUE TO STRUGGLE WITH THE ANALYSIS OF THE EXPECTED PERFORMANCE OF EXPOSURES SUBJECT TO PAYMENT HOLIDAYS"

The typical practice following the pandemic was to prohibit the inclusion of moratoria at closing or over the length of the replenishment period. Alternatively, for other trades, banks ditched replenishment altogether and opted instead for a static pool. Further measures included liquidity reserves for whatever excess percentage of the pool is subject to moratoria and shorter replenishment periods.

Nevertheless, based on 2020 deal data, it's clear that private investors have for the most part shied away from asset classes with high take-up rates of payment moratoria, such as SME loans. According to EBA data, as of June 2020, around 16% of total SME loans were reported to be under moratoria, while the share stood at less than 5% for loans to large corporates and 12% for commercial real estate loans.

"Investors continue to struggle with the analysis of the expected performance of exposures subject to payment holidays. We believe the wide use of payment holidays contributed to the decline in SME and consumer transactions in 2020 and early 2021," confirms Abrell.

Yet investors disagree on the extent to which payment holidays can be problematic, since SME pools have benefited the most from payment holidays, but historically they have performed well and governments will keep supporting them as long as they can.

Besides, SMEs are more vulnerable to macroeconomic shocks. Hence, as the virus subsides and the vaccine distribution programmes move forward, SME issuance will likely increase.

"Issuance will go up, although some sectors will suffer, following an end to government support. The EIF will also scale back its activity this year, so we expect the private market to fill in the gap," adds Terry Lanson, md at Seer Capital.

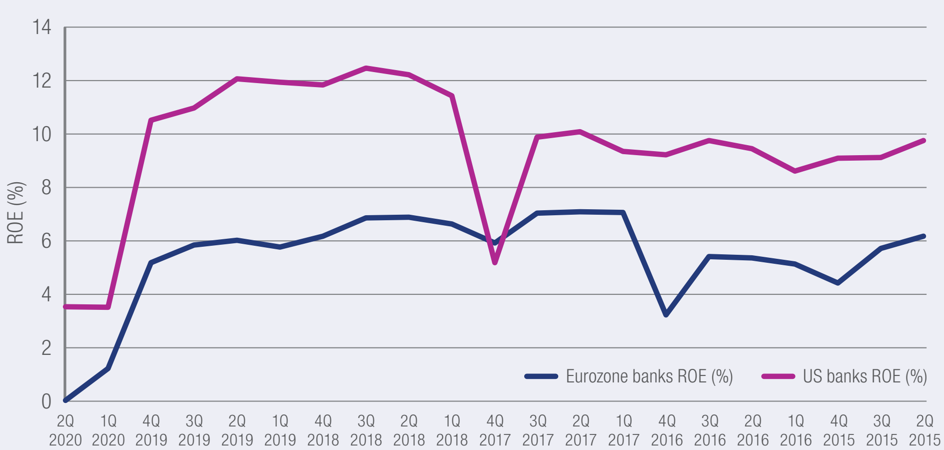
The uncertainty over expected losses due to moratoria extends to IFRS 9 loan loss provisioning. According to Autonomous Research, EU bank loss provisioning was 38bp of loans pre-Covid, but it was 85bp in 2020 and 33bp of that was for Stage One and Stage Two assets. But given the differences with which banks classify Stage Two assets, gauging the impact of the current crisis for provisioning remains unclear.

Graham remarks: "If you look at the analyst consensus for 2021, it goes down to 60bp. Clearly the market is betting that non-performing loans will go up in 2021, but also that some of that 33bp can be released because of the vaccine rollout and the economic recovery. If that's the case, then things look pretty good for the synthetic market."

Arrangers have indicated that 2021 could be the year of the IFRS 9 provisioning hedge, as banks attempt to manage provisioning increases following the coronavirus crisis for long-term assets. Nevertheless, this idea has been considered over the last four years and it remains to be seen, due to costs and structural complexities.

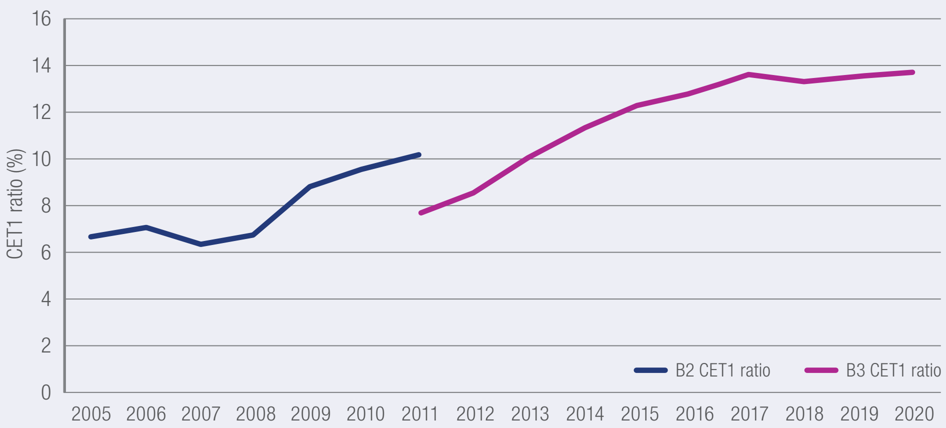
Robert Bradbury, head of structuring and advisory at StormHarbour, explains: "There is a material difference between hedging current provisions and targeting potential future provisions arising due to credit migration. The latter is essentially an 'out of the money' hedge, which is understandably cheaper. Under this structure,

Figure 1: EU and US banks' ROE 2015-2020



Source: ECB, FDIC

Figure 2: European bank CET1 ratios 2005-2020



Source: Autonomous Research

the bank would typically expect a payout during specified stress periods; however, challenges to issuance include the potential lack of recognised benefit at closing, difficulties in recognition of the relevant benefit at a future date, as well as matching investor and bank expectations on pricing."

However, the most important regulatory development whose impact for capital relief trades remains to be seen is the EBA's final SRT report,

> “LENDING TO RENEWABLE ENERGY WILL HAVE TO GROW SIGNIFICANTLY TO MEET CLIMATE GOALS”

and particularly the provisions pertaining to the treatment of synthetic excess spread. The EBA paper treats synthetic excess spread as a retained first loss tranche, which means that banks have to apply a 1250% risk weight or a full capital charge plus deduction *(SCI 27 November 2020)*.

Robert Bradbury, StormHarbour

Effectively, the transactions will most likely be rendered uneconomical due to the higher capital deduction. Nevertheless, most transactions do not use synthetic excess spread, so the impact of the new rules is not expected to be severe, although the EIF is a frequent user of the structural feature.

Meanwhile, when it comes to new asset classes, one that is emerging and will likely capture the attention of banks and investors going forward is significant risk transfer trades referencing ESG loans *(see SCI's capital relief trades database)*. According to Molly Whitehouse, director and portfolio manager at Newmarket: "ESG SRTs as an asset class offer a positive contribution to environmental, social and economic development, although the criteria can differ between fund managers. We have innovated several ESG and impact structures, including requiring liberated capital to be recycled into ESG assets, allowing banks to lend more to certain key sectors of the real economy."

She continues: "Lending to renewable energy will have to grow significantly to meet international climate goals. Luckily, investors are increasingly considering the ESG aspects of investment opportunities and overall there's been positive momentum in this direction. What is especially powerful and exciting with SRTs is the ability to not only underwrite the portfolio for ESG metrics, but also to partner with banks to improve the cost of capital for green assets on a look-forward basis."

Additionally, SRT provides an opportunity for large institutional investors to make ESG investments at scale through partnerships with the most established bank lenders. Nevertheless, although green bonds have gained traction, ESG assets are less prevalent in the broader ABS market.

Emile Boustani, head of asset-backed products UK at Societe Generale, explains: "Green bonds are now the most developed ESG asset class within the capital markets, but we do see potential in ABS. For example, auto ABS can comply with green finance frameworks by refinancing green collateral, such as electric cars, or by having issuers use proceeds from the deals to invest in the development of electric cars. Similar mechanisms can be envisaged for consumer ABS, among other asset classes."

However, not all ABS sectors are created equal. Synthetic securitisations referencing concentrated pools of corporate loans may likely benefit more from the shifting focus to ESG versus other ABS sectors.

Boustani notes: "Corporate loans – just like with corporate bonds – can be structured according to an ESG action plan and initiatives that must be executed by the borrower. However, in the ABS world, the underlying obligors tend to be multiple, so the ESG angle cannot be based on the specific undertakings of these obligors."

ESG analysis is in its infancy insofar as bank credit risk is concerned and will depend on the design of future regulatory requirements. The notion of ESG factors as potential financial stability risks is growing among bank regulators. Banks will need to demonstrate to their regulators and supervisors that ESG is firmly on their agendas and particularly their management of climate risks.

The challenge is that supervisory expectations and eventual requirements are still being determined. The EBA has consulted on the risks to which banks are exposed from the impact of ESG factors on their counterparties, while the European Commission has engaged external capital market advisors to study how ESG factors can be integrated into the EU banking prudential framework.

The issue is further complicated by the lack of a securitisation framework that incorporates sustainability-related transparency requirements, although the EBA – in cooperation with ESMA and EIOPA – is expected to publish one by 1 November 2021. ■