

# Regulatory storm?

Concern over the future viability of synthetic securitisation is rising, in light of the impending Basel output floor and the EBA's synthetic excess spread proposals. **Stelios Papadopoulos** investigates.

**T**he coming implementation of the Basel output floor and the EBA's proposal for a full capitalisation of synthetic excess spread (*SCI 11 August*) are the most salient features of a pending regulatory storm that has sparked concern about the future viability of synthetic securitisations. However, disagreements are beginning to emerge as to whether such regulatory change is likely to be as severe as it seems.

According to a Risk Control report that AFME published last month, synthetic securitisations – particularly those referencing corporate and SME loans – would become unviable under the output floor as it stands (*SCI 22 November*). Corporate and SME loans are the bulk of the capital relief trades market and, more importantly, the floor could contribute to a significant reduction in funding to the real economy.

Under the output floor, a bank using internal models must now calculate RWAs using the standardised approach and then multiply the amount obtained by 72.5%. The output floor will be gradually introduced from 1 January 2025 over a period of five years. Effectively, this may lead to higher risk weights for the retained senior tranches of synthetic securitisations.

Market participants have therefore called for the p factors to be halved. The p factors are an input into the SEC-SA and SEC-IRBA formulas, and they were introduced well before the output floor. They govern the non-neutrality for the retained senior tranches of synthetic securitisations and their aim was to address modelling and agency risks.

The p factors have gained attention with the introduction of the output floor, since although the market has generally come to accept the output floor, its impact on securitisation and significant risk transfer is highly punitive and unfair compared to other asset classes. Hence, the focus has shifted to the rectification of the SEC-SA by halving the p-factors.

If regulators don't address the output floor, market participants expect waves of regulatory calls. Olivier Renault, portfolio manager and ►



Olivier Renault, Pemberton

head of risk sharing strategy at Pemberton, notes: “A CRT transaction has a typical five-year life, so it must be efficient within that time. From the end of 2024, the output floor will be a problem that will have to be addressed and if the deals don’t work, you will see a wave of regulatory calls and that’s not something that investors will likely accept.”

However, disagreements have begun to emerge about the potential impact of the output floor. Robert Bradbury, head of structured credit execution at Alvarez & Marsal, explains: “The market can, to a certain extent, cope without the halving of the p factors, since – relatively speaking – it’s still generally much more cost-effective to do an SRT transaction than raise equity.”

He continues: “The tranches are likely to be thicker and the transactions less cost-effective due to the output floor, but it won’t prevent banks from issuing. Having said that, a range of legacy deals would likely suffer under the SRT tests following the implementation of the Basel output floor, absent suitable grandfathering provisions.”

The actual implementation of the output floor will ultimately show whether the transactions remain efficient or not. But quantitative assessments, such as the ones by Risk Control, and the broad consensus in the market still favours the halving of the p factors – despite questions around the potential severity of the output floor.

Equally, not everyone is concerned about the full capitalisation of synthetic excess spread. Some arrangers will still structure a deal with synthetic excess spread if the overall cost of the transaction makes sense (*SCI 11 November*). One arranger interviewed by SCI works with standardised banks and looks at the overall lifetime cost for a trade – including funding for the senior tranche, set-up costs and ratings – in order to decide between synthetic or true sale execution.

If the issuer is aiming for capital relief and funding and has a covered bond programme, then covered bonds along with a synthetic securitisation make more sense. This is because the cost of funding is more economical relative to the current spreads of full-stack securitisations.

However, if the aim is purely capital relief, synthetic securitisations are a one-way street. The tranching will be better under the supervisory formula, compared to the rating process under true sale, while the set-up costs are much lower.

Furthermore, and especially for IRB banks, the tranches would be effectively thinner and therefore come with lower absolute cost of premia. IRB banks can also benefit from better tranching, given the use of the IRB formula.

However, the full capitalisation of synthetic excess spread remains uneconomical as well as unfair from an originator perspective, since true sale securitisations aren’t subjected to the same punitive treatment. Ultimately, banks must risk weight a retained synthetic excess spread position at 1250%, or a full capital charge plus deduction.

tilting of the uneven playing field, against which European securitisations must struggle.”

Consequently, the same letter proposes that the “traditional approach of aligning true sale and synthetic securitisation prudential rules be followed and therefore, to the extent that the contracted SES mirrors the flow of actual cash excess spread in a traditional securitisation, the capital requirements be aligned. No prudential justification appears to us to support a more punitive approach to synthetics.”

Nevertheless, this raises the question as to how synthetic excess spread can ‘mirror’ actual cash excess spread, given that synthetic excess spread has typically been a commitment of the originator that doesn’t necessarily depend on the performance of the underlying portfolio. The letter’s answer to this question is the so-called ‘true

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PCS reiterated a similar point in its response to the EBA’s consultation on regulatory technical standards for synthetic excess spread in October. The PCS letter states: “The proposals in the RTS require capital to be set aside against synthetic excess spread calculated over the whole life of the transaction. PCS notes that a basic feature of the CRR – as a whole – is that it operates on a one-year horizon. By departing from this approach, the EBA’s proposal would result in yet another

sale mirror approach’. Effectively, PCS proposes that a pool of assets – whether securitised via the true sale or synthetic format – should generate ‘actual cash’ that should be made available to cover actual losses, which is the essence of excess spread.

Shifting to structures where synthetic excess spread mirrors actual excess spread is a contractual choice for PCS. If there is a positive difference between synthetic and actual excess spread, then PCS agrees with established regulatory practice that the difference should be capitalised.

The approach has gained a following in the market, as banks wouldn’t have to fully capitalise synthetic excess spread if it mirrored the performance of the underlying portfolio. However, it’s an approach that still begs an obvious question. Can there be a mirroring between true sale and synthetic excess spread or is the so-called mirroring more of a vague reflection?

One criticism levelled against PCS’s true sale mirror approach is that identifying which portion of a portfolio of loans is the source of the synthetic excess spread is much harder, compared to true sale securitisations, given that for cash deals the loans are transferred and segregated into an SPV.



Robert Bradbury, Alvarez & Marsal



Harry Noutsos, PCS

However, for some market participants, this criticism comes across as rather odd. Harry Noutsos, md at PCS, notes: “When you do a synthetic securitisation, you have to identify and monitor every loan in the pool and know the protection you are buying, with loan IDs being present in the pool. Asset selection is crucial in this respect to assess the risk and know the spread in the pool.”

He continues: “There is nothing that prevents you from using the same monitoring procedures for that portfolio as you would use if that pool was sold via a true sale securitisation. In both cases, the originator is the servicer and whether the loans are sold is irrelevant to the servicing approach to a given pool.”

Another question that market participants have raised is whether the true sale mirror approach considers hedges, such as interest rate swaps. Renault notes: “Fixed-rate loans are hedged by banks, but it may be done at a macro rather than on a loan-by-loan level. So, should the bank use the fixed rate as income or the swap rate – and if it is the latter, how do you calculate the hedging cost if the bank has a macro hedge, as in the case of true sale deals?”

Data is another issue. “One of the attractions of synthetics versus cash deals is that they don’t require a lot of loan data. Adopting the true sale mirror approach would eliminate this advantage, since with synthetics, the parties to the transaction don’t need to worry about cash but whether a loan is in default or not,” says Renault.

Yet the most pertinent question is determining the cost of funding. The focus on funding cost is important from a significant risk transfer perspective because it is necessary to demonstrate

that excess spread is real and not a commitment of the originator that is independent from the performance of the portfolio.

Renault comments: “You must determine the funding cost. In cash deals the funding cost is determined from the sale of the senior tranche, but with synthetics, the senior is not issued as a financial instrument since it is implicitly retained. Banks do not match each individual loan with a funding source. Funding is done at the Treasury level on an aggregate basis, which can comprise deposits, unsecured bonds and ABS.”

works well and is well understood by lenders,” remarks Renault.

The question of estimating the cost of funding via proxies or on an aggregate basis is the right question. But this is where the situation becomes complicated, judging from the different responses of market participants.

The arranger comments: “Figuring out the cost of funding isn’t an issue with true sale ABS, since you just sell the senior tranche, but it is a question for synthetics. For synthetics, we would take the price of the senior tranche of the same

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He continues: “So you can’t pin down an individual funding cost on a loan-by-loan basis. One possible solution is to use the aggregate funding cost for the banks and to assume that the hedged portfolio is funded like the remainder of the balance sheet, but you can’t be specific about the funding cost of the underlying loans.”

Additionally, how is it possible to know the administrative costs for a specific pool? Yet again, banks could consider an aggregate or proxy measure, but servicing retail pools relative to large corporates or specialised lending could result in very different costs. With cash deals, the cost of servicing is straightforward, since banks charge the SPV for services.

Nevertheless, “overall, the PCS approach is intuitively attractive and could work if regulators are willing to let banks estimate the various costs on an aggregate basis. PCS also does have a valid point in the sense that if banks can demonstrate proper risk transfer, there’s no need to discriminate against synthetics. The ECB’s one-year rule

asset class as a proxy for the synthetic excess spread in the deal.”

However, how should the ‘true market value’ or ‘true return’ of the senior piece be determined, if it is to eventually be retained? Bradbury concludes: “One possible solution here could be to formalise the approach of demonstrating the ‘market’ value of the senior note as part of the SRT tests by using benchmarks from other markets and other suitable proxy approaches. Clearly, this will always be subjective to a degree. But embedding this into the already detailed SRT process would help set standards for how this could be done, while minimising basis between securitisation types.”

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