Positive prospects

Risk-sharing deals involving the EIF and private investors are yet to gain ground. Stelios Papadopoulos surveys the likelihood of such collaborations going forward.

Significant risk transfer transactions between banks on the one hand and insurers and hedge funds on the other have grown substantially over the last two years in deal count terms. However, risk-sharing deals involving the EIF and private investors are yet to gain ground, seemingly due to the EIF's due diligence requirements on potential counterparties. Nevertheless, these requirements only apply to certain types of risk-sharing deals, raising the prospects for EIF and private investor collaborations going forward.

The entrance of insurers into the capital relief trades market took off approximately three years ago, thanks to the advent of the new Securitisation Regulation. According to Giuliano Giovannetti, md at Granular investments: "The thicker tranche requirements of the new Securitisation Regulation have been a big driver behind the arrival of insurers into the market. Thicker tranches mean that either the coupon on the tranche must collapse – which is difficult for hedge funds – or risk needs to be shared in some other form and attach higher up. This is where insurers have played a clearly positive role."

The Securitisation Regulation's higher senior risk weights has forced issuing banks to mitigate the capital increase by structuring transactions with thicker junior tranches. This is because the more credit risk a bank transfers lower down the capital structure, the better the rating for the senior tranche and hence the lower the associated risk weight.

However, if an issuer is forced to sell thicker tranches to achieve significant risk transfer, such a sale will not be economic for the bank if investors do not agree to accept the correspondingly lower return that comes with these thicker tranches. This is where the value of splitting, or re-tranching, the junior risk into first- and second-loss pieces enters the picture *(SCI 26 January 2018)*. The resulting mezzanine tranches matches the risk/return requirements of insurers and offer banks competitive pricing and strong counterparty credit ratings.

There are potential alternative investors for the mezzanine notes, such as life insurers and pension funds. However, SRTs are usually classified as alternative investments, where such investors can only allocate a small fraction of their assets.

"It's more likely that these investors participate in SRT through hedge funds, rather than directly," says Giovannetti.

Another alternative is the EIF. "The EIF has certain known advantages, since its zero-risk weight status means that it is as good as cash. Additionally, the credit risk limits that the banks have towards the EIF are likely large, while with insurers, they may have to allocate limits to other products such as single name protection. Yet the EIF is limited to what it can guarantee, given its mandate around SMEs and – despite its supranational status – its eligibility criteria are conservative, and not all banks are comfortable with the additional restrictions imposed by an EIF transaction," Giovannetti adds.

One credit portfolio manager at a large European bank concurs. "The EIF is different because it is stricter with its eligibility criteria and ▶

Robert Bradbury, StormHarbour

"TRANSACTIONS WHERE THE RISK IS SHARED BETWEEN SUPRANATIONALS AND OTHER MARKET PARTICIPANTS ARE RARE"

portfolio construction, putting it effectively in the driving seat in selecting the reference portfolio. Naturally, it is limited to SMEs, but it is also wary of keeping the portfolio balanced without overweighting certain industries," he explains.

He continues: "Furthermore, the EIF isn't as flexible on the replenishment period, preferring instead amortising pools or shorter revolving periods. Nevertheless, this is expected, given the different mandate of the institution."

Meanwhile, pricing from insurers is typically competitive. "What we further need are investors with a good understanding of the collateral. Insurers understand retail pools well, since, unlike asset managers, they are looking for less risk and more granularity," the portfolio manager observes.

Consequently, depending on the circumstances, banks are willing to surrender control for the pricing benefits or to facilitate new business. The latter is particularly pertinent for smaller portfolios and regional lenders, where the EIF has been overall more active compared to private investors.

However, precisely because of these differences in flexibility, transactions involving both hedge funds and the EIF would be cumbersome. Originators note for instance that the EIF would insist that the participating bank comply with the SME definition of the European Union, when that might contradict the needs and requirements of hedge fund investors as well as banks.

The main criteria determining the definition of an SME, according to EU law, is staff headcount and either turnover or balance sheet total. Staff headcount for small and medium-sized businesses is over 50 and 250 respectively. Turnover is €10m and over for small firms and €50m and over for medium-sized firms.

However, when it comes to risk-sharing transactions, the most salient concerns are the EIF's due diligence requirements – which range from background checks on the managing partners, ownership and how the funds consolidate due to their presence in different parts of the world – including vehicles in offshore jurisdictions – to information on their investor clients. The due diligence is not just an issue given the confidential nature of the requested information, but it will also further prolong the execution process and render it more costly and cumbersome for private investors.

Robert Bradbury, head of structuring and advisory at StormHarbour, comments: "The EIB has a well-trodden list of requirements, so you know exactly what they need to ask from an originator. They also have a great deal of standardisation in documentation, given the number of transactions they have executed, so are able to rapidly adapt every transaction feature to a specific situation. Real money accounts and funds tend to deploy money quickly, so time is not as much a constraint for the EIF as it is for private investors."

The only risk-sharing transaction known to have been executed so far is one issued by BCC Grupo Cajamar *(SCI 9 January 2019)*. The €972.1m Spanish true sale SRT transaction was completed between the EIF, Spanish state owned bank ICO and hedge fund investors.

The class A notes were split into €319.3m and €283.4m that were guaranteed and purchased respectively by the EIF and Spanish state-owned bank ICO. The EIF also guaranteed the class B and C notes with back-to-back guarantees from the EFSI. Hedge funds bought the class D and E notes.

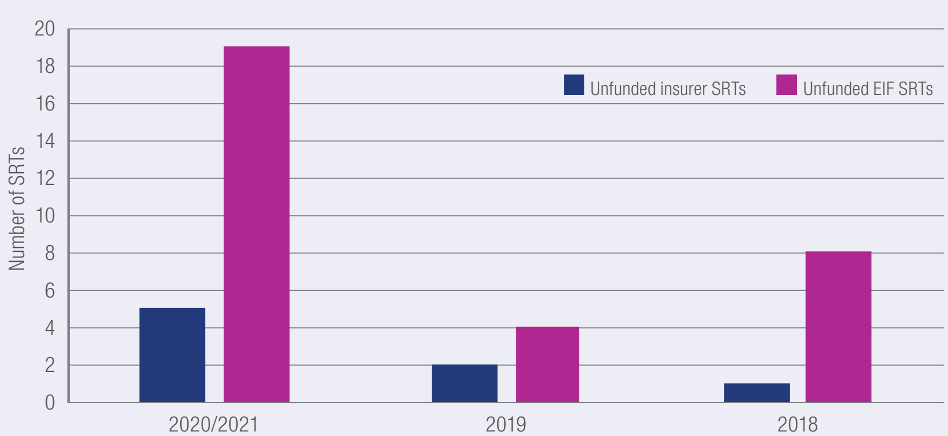
"Transactions where the risk is shared between supranationals and other market participants are rare. One exception is the Cajamar transaction, where the participation of ICO was particularly important," Bradbury says.

He adds: "Ultimately, if you only have supranationals, you will typically be limited in size terms, due to single counterparty restrictions and risk concentrations. In the Cajamar deal, the senior risk was a good fit for that kind of investor, and it worked broadly within the existing structure. It is less likely that a 'traditional' SRT investor would be interested in a similar proposition."

Apart from the additional expense of having a traditional SRT investor participate, their inclusion alongside a supranational is likely to add time and complexity for the sponsor, given the need for their own in-depth credit analysis. "It is certainly a proposition that can work, but the asset perimeter, pricing, timing and other factors need to line up very well," Bradbury notes.

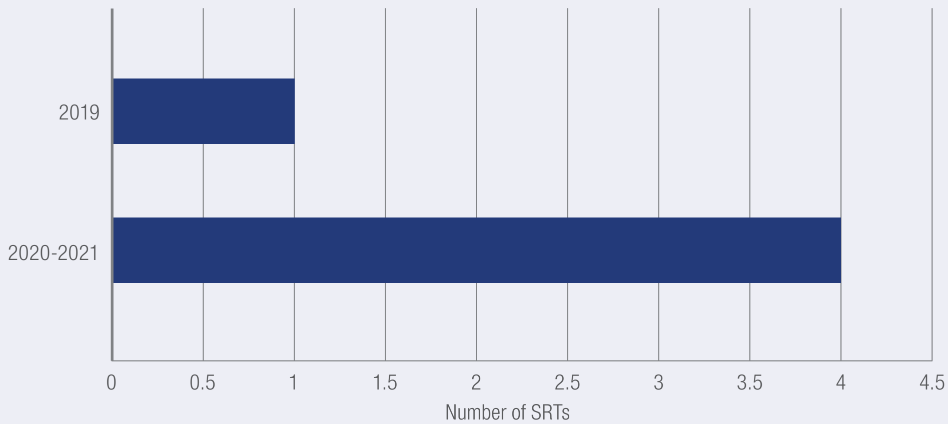
Indeed, the Cajamar transaction indicates the types of risk-sharing deals that can and can't work. Pablo Sanchez Gonzalez, head of Southern European securitisation at the EIF, explains: "We are here to cover market gaps, so from time to time we have mandates from EU states to boost these markets. Consequently, our participation isn't a competition with private investors but to facilitate transactions, working as an equaliser to bring structured finance expertise where it is currently insufficient, and thus allowing midsize and smaller banks to access this market."

Figure 1: Number of unfunded SRTs 2018-2021



Source: SCI data

Figure 2: Number of funded and insurer unfunded SRTs 2019-2021



Source: SCI data

He continues: ''So if a jurisdiction is commercially attractive to private investors, we are willing to step aside, such as the pre-pandemic economy which was performing well and when our resources were limited. Bringing onboard private investors allows us to use our resources more efficiently to do more transactions. However, the pandemic opened a large market gap – particularly for smaller tier two banks – so we had to intervene, and we were able to do so following the launch of the European Guarantee Fund.''

"THE EIF HAD HISTORICALLY A LARGE BALANCE SHEET, SO THEY ARE QUITE HAPPY DOING DEALS BY THEMSELVES"

Announced in May 2020, the €25bn European Guarantee Fund (EGF) aims to help European SMEs finance their way out of the coronavirus crisis *(SCI 27 May 2020)*. All 27 EU Member States have been invited to contribute to the €25bn fund with a portion equal to their share of EIB capital.

Pablo Sanchez Gonzalez, EIF

The EGF will enable banks to buy low mezzanine and first loss protection for SME synthetic securitisations for a ''limited period''. Hence, Gonzalez confirms that when the market returns to a more stable path, there will be opportunities to combine public and private resources.

However, risk can only be shared under two formats. The first is a mezzanine guarantee, where the EIF and private investors face the bank either on a pari passu basis or via an upper and lower mezzanine tranche respectively.

The second option involves a bilateral guarantee between the EIF and a bank, which is then counter-guaranteed by a private investor. Overall, although private investors may consider the first option, the second one will raise eyebrows since this is where the costly due diligence requirements enter the picture.

The EIF will have to carry out these checks under the second option because the hedge funds will be, by definition, one of the two counterparties in the transaction. However, Sanchez qualifies that the KYC challenges apply more to American funds than European investors, such as several large asset managers who are physically located in Europe.

"It's the American funds who tend to be more complex and sometimes a concern on the due diligence process because they are more global and often linked to offshore jurisdictions. In any case, the EIF is well equipped to carry on its KYC and compliance due diligence for all types of counterparties,'' he explains.

Asset managers contacted by SCI have confirmed these concerns, but they also unequivocally outlined the benefits that EIF participations can bring. The EIF has knowledge and familiarity of certain markets that private investors are not necessarily privy to.

Time will tell whether funds will get more on board with the idea of sharing risk with supranationals, but these investors aren't the only alternative. In fact, another possibility are trades involving the EIF and insurers, owing to the growth in insurer participations and increasing standardisation in the market. Bradbury believes that supranationals can support most of the capital structure, while insurers can take the risk that fits their risk/return profile.

Andy Garston, md at Credit Risk Transfer Solutions (CRTS), notes: ''The EIF had historically a large balance sheet, so they are quite happy doing deals by themselves. Yet we've seen trading where the EIF takes the senior mezzanine and insurers take the junior mezzanine along with the first loss investor. It just reflected a moment in time when there was a need to bring in more capital into this space and insurance had at that point become a visible option.''

The prospects look brighter, thanks to the existence of new structures that allow insurers to face banks on both a funded and unfunded basis *(SCI 11 June)*. CRTS is the firm behind them and they are typically mezzanine deals that involve an investment platform managed by a broker that acquires and holds the related CLN. Insurers then cover the risk on the CLN, without having to deposit cash.

CRTS is an FCA authorised and regulated insurance broker, with a focus on structuring and arranging credit risk transfer – both primary and secondary participations – from banks to insurers, particularly in the context of SRT transactions. Thomas Oehl, director at the firm, concludes: "From a pure cost perspective, insurers are incredibly competitive. However, you have to go one step further and consider the benefit of a multilateral like the EIF as a zero-risk weighted entity, as well as collateralised protection which also carries a zero-risk weight. This becomes even more pertinent with the EU's new synthetic STS framework.''