High-quality counterparties

Insurer involvement in the SRT market is on the rise. A growing need for post-coronavirus capacity by banks means their participation could become meaningful in the coming years, as **Corinne Smith** reports.

Having historically suffered from a lack of visibility in the capital relief trades market, insurers are gaining traction as adaptable, scalable and high-quality counterparties. Indeed, a growing need for post-coronavirus capacity by banks means that insurer participation in significant risk transfer is likely to become ever more meaningful in the coming years.

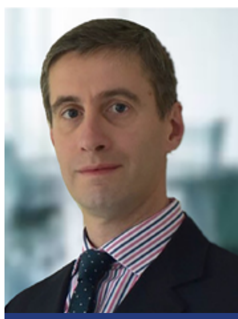
Insurers began entering the capital relief trades market three years ago, but their participation has increased significantly over the last two years, according to Texel broker Alan Ball. He reckons that there are currently eight active insurers, accounting for 15-20 SRT deals executed across a range of asset classes.

"Insurers represent a developing investor base, but one that is able to scale and adapt quickly," says Ball. "They provide diversification of risk appetite, economic advantages and represent excellent counterparty credit risk. Most credit insurers are prudentially regulated multi-line insurers, with balance sheets that are highly diversified away from the credit risk they assume as part of their credit insurance business."

He adds that the credit insurance industry has an outstanding claims payment track record. "It's worth noting that 100% of all credit insurance claims in the London market over the last two years have been paid in full and on time. Over the last 13 years, London market data shows that only in a tiny minority of cases (less than 4%) were claims not paid in full and in these very limited cases, the reason for non-payment was breach of a policy condition which was entirely within the control of the policyholder – a possibility that is even less likely to arise in insurance on SRT transactions, given the terms of insurance cover used on these transactions."

Robust counterparties

In addition to excellent and proven claims performance, non-correlated counterparty risk and prudential regulation of insurers, where an insurer is Solvency 2 (or equivalently) regulated, banks benefit from preferential treatment as policyholders in the event of an insurer insolvency. "It's worth highlighting these points, as they are often not appreciated at all or can be notably underappreciated," Ball says. ▶



Giuliano Giovannetti, Granular Investments

He cites as examples the fact that insurers are classed as corporates under the CRR, as well as the provisions of the STS framework regarding unfunded protection which exclude insurers – despite their prudential regulation, the performance of the product and the uniquely robust counterparty credit risk of credit insurers.

Giuliano Giovannetti, md at Granular Investments, notes that while insurers are unlikely to ever replace hedge fund participation in CRTs, they could potentially account for 25%-30% of the market in time. "Significant risk transfer is still relatively unchartered territory for insurers," he explains. "The US GSE CRT market is well-established and the transactions have common characteristics. In Europe, the transactions are less standardised and the relatively small number of unfunded deals has made it harder for insurers to familiarise themselves with the key regulatory and structural requirements embedded in CRT transactions."

First loss credit risk is something that insurers intuitively understand, but the mechanics of SRT are new to them and so they need to build up their knowledge base, according to Granular Investments' other md Richard Sullivan. "Credit funds in this space already have relationships with banks and a good understanding around underwriting. We would ask banks to be understanding that insurers are likely to ask more involved questions, but the long-term benefit is that they will have a more diversified investor base than just cash investors."

Fiona Walden, svp and global head of credit at RenaissanceRe, notes that her firm's approach to risk in the context of a capital relief trade is broadly similar to that of a funded investor. "We undertake the same due diligence in terms of analysing data tapes and gaining access to the relevant teams within the originating bank. We also use stochastic models to analyse the risk on a through-the-cycle basis, taking into account qualitative and quantitative factors. Additionally, we view SRT transactions as portfolio deals – in other words, a pool of exposures, versus single name exposures."

She continues: "The difference is that we don't view SRT from a yield perspective, since we don't have to meet hurdle rates, but from a likelihood of loss perspective. In this respect, we can bring a competitive pricing advantage over funded investors. However, funded and unfunded investors are not mutually exclusive – reinsurance capital provides diversification."

Structuring

Generally, unfunded deals are more straightforward to structure than funded deals, since neither an SPV, nor a stock exchange listing are necessary because protection is in the form of a direct guarantee. Insurers also provide flexibility and diversity in terms of risk appetite and underwriting expertise, with reinsurers tending to be comfortable with junior and mezzanine tranches and insurers typically more comfortable with mezzanine tranches.

Frequent SRT issuers have fairly standardised programmes in place and a plan for their pipeline. Sullivan indicates that when banks are planning their issuance for the year and mapping investor appetite, insurers aren't necessarily the first choice. This makes it more difficult to involve them at a later stage.

"Sometimes there are situations where a bank may have a more challenging exposure that is more naturally placed in the insurance market. Also, a Standardised Bank or Standardised portfolio that requires a thicker risk layer to be transferred and where a cash solution is too expensive from a cost of capital released and where insurance would be more efficient. In the short term, the challenge is to persuade banks to consider insurers as an alternative to funded investors rather than a plan B," he says.

> "SOMETIMES THERE ARE SITUATIONS WHERE A BANK MAY HAVE A MORE CHALLENGING EXPOSURE THAT IS MORE NATURALLY PLACED IN THE INSURANCE MARKET"

Not only does this create synergies in deals where – due to the underlying assets being a standardised approach portfolio – the issuer needs to place a thicker tranche, it also enables funded and unfunded investors to participate in the same deal to optimise the capital relief achieved even further. Notable recent examples of transactions with such a mix of investors include Bank of Ireland Group's Vale Securities Finance 2019-1 from December 2019 and BNP Paribas' Resonance Five from September. In the former deal, seven funded investors and RenaissanceRe participated for the first time in the junior mezzanine tranche on a side-by-side basis, while the latter's mezzanine tranche was split into a funded €324m CLN and an unfunded €100m insurance policy provided by RenaissanceRe.

Fiona Walden, RenaissanceRe

He adds: "It is clear that banks will have to deal with problematic loan books over the next few years, due to the Covid-19 fallout, so will need as much capacity as possible. As such, it makes sense to start engaging with insurers."

Whether an issuer opts for a funded or unfunded transaction is ultimately based on certainty of execution. Frequent issuers need to bring a minimum number of deals, with no unforeseen issues, and execution risk can be a concern when contemplating an unfunded deal.

"Banks typically prefer funded transactions, as they are used to dealing with certain funds and so have a reasonable expectation that the deal will close. In contrast, the perception is that insurers may ultimately be unable to get the necessary internal approvals. Having experienced advice from the start alongside the insurers reduces execution risks on both sides," observes Giovannetti.

Partnerships

RenaissanceRe, for one, has executed a number of repeat deals and Walden says that client relationships

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are key to its approach. "SRT is about creating partnerships with banks; the aim is to create a sustainable pool of capital and place capacity with a mutually beneficial outcome. SRTs are living and breathing structures, not point-in-time static transactions, so the ability to maintain an ongoing dialogue is crucial," she explains.

She adds that the coronavirus crisis highlighted this point, as well as the resilience of the SRT sector. "In March through May, we had good conversations with our partners and were able to execute the first post-lockdown deal at the end of June. We were able to provide certainty of execution; we understand deals and can deliver them."

Ball agrees that insurers value partnerships in the context of SRT deals. "Transparency and engagement by the bank are important, as they enable both sides to understand each other's perspective and have sensible discussions over any gaps. Insurers don't want to be used as a stalking horse by banks, but they are willing to learn and engage and have enough resources to be meaningful counterparties. Insurers look for a good underwriting story and alignment of interest for the long term."

Alan McNamara, head of financial solutions and markets execution for Bank of Ireland Group, says that his firm's experience working with RenaissanceRe on the Vale 2019-1 transaction was "seamless and streamlined". He highlights a number of benefits that insurer participation in the SRT market provides, including counterparty diversification, attractive pricing and greater flexibility in terms of deal tenor.

"In our experience, there were no impediments to bringing in unfunded investors from a regulatory perspective. The key is to have a clear understanding of the additional factors involved; for example, the possibility that they may be downgraded – in which case, they could potentially post contingent collateral," McNamara observes.

He continues: "For esoteric assets or in difficult market conditions, it makes sense to have a deeper market and the ability to print transactions. The more investors participating in the market, the better the execution. Providing you comply with the CRR, unfunded deals are straightforward."

Giovannetti agrees that insurer participation in the CRT market helps to create a diversified base of protection providers. Indeed, Granular Investments works with a panel of five insurers that functions like a syndicate, comprising different risk appetites across the spectrum.

"From an insurer perspective, the advantage of the panel is comfort in taking novel risk exposures, since they're sharing the risk with other insurers. From the bank's perspective, by pooling resources, insurers can come up with offers for an entire risk layer. Some will pitch for US$10m-US$20m of exposure, while others could pitch in excess of US$100m," he explains.

David Saunders, executive director, private debt mobilisation, notes and structuring at Santander, says that working with a panel of insurers and reinsurers on the firm's first unfunded deal – dubbed Project Meno – was a positive experience. "The panel had a deep technical understanding of the key structural points of SRT. A number of SRT regulatory requirements are set in stone and so it is helpful when investors are aware of them and understand which features are up for negotiation and which aren't. The panel also demonstrated a constructive approach to resolving issues in a tight timeline."

Covid fallout

Meanwhile, the insurer response to the Covid-19 fallout can be split into two broad categories, according to Ball. On one hand, many that were exploring SRT transactions but were yet to execute a deal have slowed their entry into the space. On the other hand, a number of insurers that already had experience of executing SRT transactions remain open to looking at new transactions and have, in some cases, offered terms on new transactions.

As proposed regulation stands at the moment, there is no scope for an unfunded approach to STS synthetics, which somewhat disadvantages insurers from a pricing perspective. Giovannetti suggests that insurers are regulated and already pay trillions in claims, so concerns about their credit standing are misplaced. But if insurers become more visible in the CRT space, the regime may eventually evolve to include them in the label.

In the meantime, he indicates that insurers have two options: working with banks on deals that aren't STS-compliant; or finding a way of participating in a cash collateralised manner. "The latter option is contrary to the insurer business model. It's not impossible, but it would require some work."

Whether an SRT deal is labelled as STS or not, its success will ultimately depend on the capital saving versus cost of capital, according to Saunders. "We will continue to work with both funded and unfunded investors," he confirms.

Nevertheless, Saunders suggests that insurer appetite for SRT needs to grow to help standardised bank issuers in particular, which have to place thicker tranches under the CRR. "We expect more deals to be issued whereby thicker tranches are split and funded investors take the first loss/junior mezzanine tranche and unfunded investors take the senior mezz. It can be a win-win situation for both types of investors," he concludes.

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