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Significant risk transfer solutions can reduce non-payment exposure for European banks

Insurance-based SRT products can provide banks with regulatory capital relief on loan portfolios, creating opportunities to drive growth in the highly stressed post-Covid environment

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European-domiciled banks have for the past two decades turned to the securitisation market to optimise their balance sheets from a regulatory perspective. Significant risk transfer (SRT), in the context of the European securitisation regulatory framework, refers to portfolio-level risk-transfer strategies that offer European banks regulatory capital relief on those portfolio portions (typically senior tranches) that are retained unhedged.

SRT solutions can be executed on a funded basis via note purchases by, typically, specialist credit funds that are dedicated to the SRT area and/or on an unfunded basis via non-payment insurance coverages offered by various credit insurance market participants. Banks buy these policies to optimise their balance sheet concentrations to various risk asset classes and so SRT can offer a competitive advantage for insured banks to grow their business and reduce capital allocation requirements.

Regulatory environment

Over the past few years the regulatory environment has evolved to drive increased levels of protection for capital relief targets to be achieved. Market demand has grown for SRT insurance strategies overall, especially as part of more risk-remote second loss/mezzanine tranches. Insurers may view participation in SRT transactions as an attractive opportunity to build exposure to a diverse and granular book of business they may not otherwise see as part of their usual deal flow.

At its core, SRT is a transaction structure that derisks loan portfolio exposure by transferring the risk of aggregate borrower non-payment to a third party. Loans achieving SRT share common characteristics that result in the application of well-defined eligibility criteria, which categorise loans to be included.

The resulting portfolio will undergo an analysis to determine its expected loss over the lifetime of the transaction and that calculation informs the thickness of the tranches that ultimately must be protected by funded and/or insurance solutions. While offering capital relief, the portfolio loans remain on the bank's balance sheet for continued servicing and, importantly, the bank must retain a material net retention to the performance of the portfolio for structural alignment of interest purposes.

SRT solutions can involve such corporate loan assets as trade finance loans, loans to small and medium-sized enterprises, infrastructure and project finance loans, mortgage loans and other asset classes.

Internal ratings for individual assets to be inputted in solutions range typically from B to investment grade; the eligibility criteria for portfolio construction generate output SRT mezzanine tranche attachments that often model at high non-investment grade or even investment-grade levels. Transactions typically have lifecycles of five to eight years, with the first portion designated as a replenishment period where the bank can allocate new transactions to the structure to replace amortisations. Usually, there is a call feature permitting the originating bank to terminate the structure, which most often occurs soon after the replenishment period ends to optimise regulatory capital outputs.

The level of protection required for the bank is determined by the respective regulator and must be approved to achieve SRT designation. All banks are different and capital requirements established by regulators vary from region to region. Larger banks follow guidance set forth by the European Banking Authority (EBA), as it serves to establish a common set of regulatory rules, offering a consistent approach for structuring SRT transactions. Banks must undertake comprehensive due diligence to assess anticipated risk of loss exposure on selected loan portfolios before submitting documentation to the EBA or other regulator for a determination to achieve SRT.

To do this, banks use sophisticated models to assess anticipated loss exposure of the loan portfolio and determine how much protection they should buy to cover losses in a highly stressed scenario and to demonstrate to the regulator that SRT has been achieved.

Historically, banks were required to hold 7% cover for the 1% expected loss during the life of the portfolio. A loan portfolio valued at €1bn ($1.12bn) would secure close to €70m in cover from credit funds that sell default protection on a cash-collateralised basis through monies raised from institutional investors.

Mezzanine layers

Over the past two to three years, the EBA has increased protection levels ranging from 8% to 10% to cover the same 1% expected portfolio loss. It is usually uneconomic for credit funds to participate in the SRT market at more risk-remote levels, causing a gap in coverage for the bank, while creating an emerging market opportunity for insurers on these mezzanine layers.

Credit funds take the position as junior investor by providing up to 7% cover in cash-collateralised backing and the insurer assumes the 7% to 10% cover as a mezzanine-level risk. Regulators in the EU are extending approvals to transactions that deploy a combination of credit funds and credit insurance for a shared portfolio risk management strategy to achieve SRT.

SRT risk management strategies are collectively beneficial to the interests of all parties; the banks, EBA, credit funds and insurance companies. According to experts, SRT mezzanine insurance presents a high-grade risk, offering favourable returns on a diversified portfolio of loans.

The analysis of the individual portfolio typically requires a thorough quantitative analysis, modelling the expected performance of the loans and a qualitative analysis, examining the controls in place within the bank and its ability to manage its loan book from origination to repayment. The insurer also benefits from a strong alignment of interest with the credit fund providing first loss protection, who must carry out a similar analysis without the benefit of another party to absorb any initial losses.

The SRT concept is continually evolving and being further refined as the strategy is becoming more commonplace and accepted in the European regulatory framework.

The underlying benefits are unequivocally proven as SRT insurance eases the bank's overall non-payment exposure on a range of assets and reduces capital allocation requirements for more efficient, profitable portfolio risk management.

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