



Parallel Round Table: Regulatory Capital Optimization

Synthetic Risk Transfer Instruments

ABI Funding & Capital Markets Forum 2014

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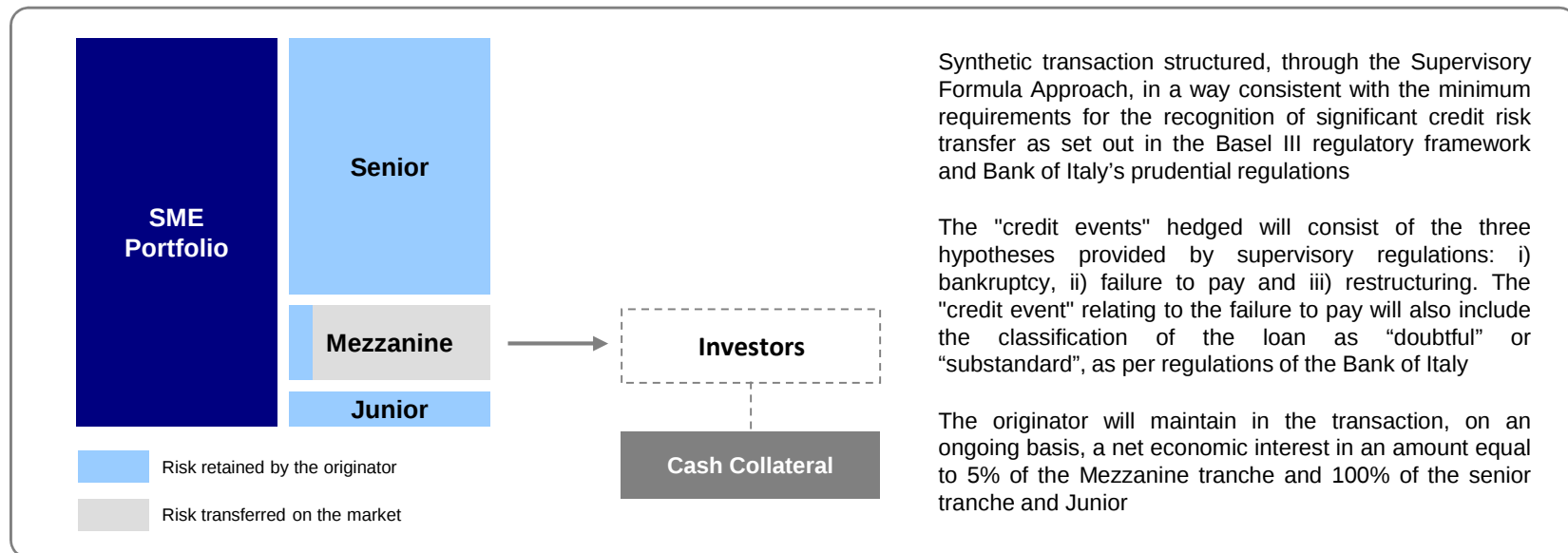
Synthetic Risk Transfer Instruments

Introduction

- Capital management has probably never been more important for banks than it is today. Worldwide, and especially in Europe, the industry is confronting a severe capital shortage, driven primarily by new regulations (Basel 2.5 and Basel 3 will raise the quality of capital, making some forms of capital ineligible for regulatory purposes) and the increased volatility of financial markets
- The management of capital adequacy consists of a series of policies that determine the size and optimal combination of the various capitalization instruments, in order to ensure that the levels of capital of a bank are consistent with the risk profile assumed and meet the supervisory requirements
- The concept of capital at risk differs according to the basis of its measurement, and different target levels of capitalization are established: (i) **Regulatory Capital** for Pillar 1 risks and (ii) overall **Economic Capital** for Pillar 2 risks, for the Internal Capital Adequacy Assessment Process (ICAAP)
- The Regulatory Capital and the overall Economic Capital differ in terms of their definition and the coverage of the risk categories. The former derives from the formats laid down by the supervisory provisions and the latter from the identification of the significant risks for the bank and the consequent use of internal models for the exposure assumed
- Capital Management essentially involves the control of capital soundness through the careful monitoring of both the regulatory constraints (Basel 2 Pillar 1) and current and prospective operational constraints (Pillar 2) in order to anticipate any critical situations within a reasonable period of time and identify possible corrective actions for the generation or recovery of capital
- Most institutions started programs to optimize capital and RWAs through different internal and external solutions:
 - INTERNAL SOLUTIONS:**
 - improve the coverage and granularity of risk models
 - improve the quality of data entered into models
 - improve the eligibility of collateral
 - improve the RWA-relevant processes
 - CAPITAL MARKETS SOLUTIONS:**
 - outright asset disposal
 - structured asset disposal
 - credit risk transfer solutions
- Credit risk transfer solutions and in particular “synthetic” capital markets instruments are considered among the most important instruments for hedging credit risk and optimizing capital consumption

Synthetic Risk Transfer Instruments

Case Study: SME Synthetic Securitisation



- The purpose of the transaction is to mitigate the credit risk and freeing-up economic and regulatory capital. According to an insurance mechanism, second losses on the underlying portfolio (Mezzanine tranche) are transferred from the originator to the investor in exchange for payment (periodic fee)
- The originator stabilizes provisioning on the hedged portfolio, even in the context of economic downturn, limiting the negative impacts on capital arising from unexpected losses (i.e.: economic capital)
- Also, the possibility of using the Supervisory Formula Approach would free-up regulatory capital (Core Tier 1), at a time when the alternatives (e.g. capital increase) are expensive

Synthetic Risk Transfer Instruments

Structuring Considerations

Size of Transaction

- Consideration should be given to sizing the notional of risk to be placed
 - Investors ticket size generally between € [50 - 150] mln
 - Assuming one or two investors this would imply a minimum portfolio size between € [1 - 2.5] bn

Tenor / WAL

- Protection generally needs to hedge the tenor profile of the underlying assets (e.g. transactions on long-dated assets like infrastructure loans will have a longer tenor than transactions on shorter-dated SMEs)
- Typical transaction tenor between [5 - 10] years with a WAL between [2.5 - 5] years depending on asset class, portfolio and structure
- Call features (to be discussed with the Regulator) may be considered to shorten the duration of the trade and to make them capital efficient for the originator as efficiency generally decreases as the underlying portfolio amortizes
- A shorter trade tenor can potentially increase the universe of investors

Replenishment

- Replenishment of underlying portfolio is possible subject to constraints at both a loan and portfolio level. Level of constraints can be structured so as to vary according to observed performance of the portfolio

Structure of Risk Transfer

Variety of structures possible:

- Cash securitization: loan assets are transferred to an SPV, junior and senior notes issued, notes sold to investors provide risk transfer. These structures can be attractive due to the possibility of additional benefits such as financing on the senior tranche, however this option requires the longest execution process and may not be feasible given disclosure requirements
- Synthetic securitization: loan assets remain on originator's balance sheet, originator buys credit protection via Financial Guarantee from an SPV. The SPV issues a CLN which is purchased by the investor
- Synthetic securitization (tranching cover): loan assets remain on originator's balance sheet, originator buys funded credit protection through a pledge over cash collateral provided by the investor