UPDATE

Significant Risk Transfer Transactions

Introduction

The recent decision by the Swiss Financial Market Supervisory Authority ("FINMA") to write off the Additional Tier 1 bonds ("AT1 bonds") issued by Credit Suisse in March 2023 highlighted the risks and uncertainties associated with this form of regulatory capital and placed the market under significant pressure. AT1 bonds are hybrid instruments that combine features of debt and equity, designed to absorb losses and recapitalise the issuer in times of stress. However, they also expose investors to the possibility of conversion into equity, coupon cancellation and, as in the case of Credit Suisse, principal write-down at the discretion of regulators such as FINMA or of the issuer, depending on the terms of the bonds.

As this was the first time a major European bank wrote off AT1 bonds since Banco Santander bought Banco Popular in 2017, questions have been raised about the attractiveness of this form of capital instrument and banks are considering alternative ways to enhance their capital position and reduce their risk-weighted assets ("RWAs"), without issuing new AT1 bonds or diluting their existing shareholders.

Significant Risk Transfer (SRT) Transactions

One alternative is to enter into the well-established SRT market, which involves the transfer of credit risk from a bank's portfolio of assets to a third party, such as a special purpose vehicle ("SPV"), insurer or another financial institution. By transferring a significant portion of the credit risk, the bank can reduce its RWA and free up capital for other purposes.

SRT transactions can take various forms, such as true sale or synthetic securitisations, credit derivatives or guarantees. The choice of structure and counterparty depends on various factors, such as the type and quality of the assets, regulatory treatment, market conditions and the cost and availability of funding. SRT transactions can also be tailored to meet the specific needs and objectives of the bank and of the risk taker, such as the level and timing of risk transfer, allocation of losses, sharing of profits and the provision of liquidity and credit enhancement. They may also qualify for STS treatment under the EU Securitisation Regulation[1], including at the warehouse stage.

What makes SRT transactions particularly attractive to banks is the fact they can be done with both performing and non-performing assets. The majority of performing-asset SRT transactions are synthetic, while SRT transactions with non-performing loans are done via cash transactions as this allows banks to fully cleanse their balance sheets. The ECB has stated[2] that since 2018, 30 banks have been active in SRT transactions involving performing loans and 13 banks have securitised non-performing loans.

Advantages

SRT transactions offer several advantages for banks seeking capital relief, such as the following.

Flexibility and Customisation
SRT transactions are designed to suit the specific characteristics and objectives of the bank and risk taker and can be adapted to changing market conditions and regulatory requirements.

Efficiency and Cost-effectiveness
Banks are able to achieve capital relief without issuing new AT1 bonds or diluting their existing shareholders, and without transferring the legal and economic ownership of the underlying assets. SRT transactions can also reduce the funding and liquidity costs for the bank by

[1] Regulation (EU) 2017/2402 dated 12 December 2017

[2] ECB Supervision letter: 18 May 2022

allowing it to access alternative sources of financing and diversify its investor base.

Risk Diversification and Management
SRT transactions allow the bank to transfer the credit risk of a portfolio of assets to a third party that has a different risk appetite and profile and can provide credit enhancement and liquidity support to the bank. SRT transactions also help the bank manage its concentration and correlation risk and align its risk and return profile with its strategic goals.

Legal Basis

The European legal framework for the use of SRT transactions as a capital relief tool is provided by Articles 243 (Criteria for STS securitisations qualifying for differentiated capital treatment), 244 (Traditional Securitisation) and 245 (Synthetic Securitisation) of the Capital Requirements Regulation[3] ("CRR"). It is also grounded in the guidelines of the European Banking Authority on the assessment and supervision of SRT transactions, including verification of risk transfer, identification of the originator and investor and monitoring of transaction performance.

Conditions

The CRR allows banks to recognise the effect of SRT transactions on their capital requirements, subject to certain conditions and the granting of supervisory approval.

The main conditions are that the credit risk transfer must:

(a) be effective and permanent, meaning the bank must not retain any material economic exposure to the transferred risk and must not provide any implicit or explicit support to the risk taker that would undermine the risk transfer;

(b) be reflected in the bank's internal risk management and reporting systems and must be disclosed to the public in accordance with CRR requirements;

(c) not result in any significant increase in the bank's operational, market or liquidity risk, or in any significant residual or contingent risk for the bank;

(d) not create any new or complex risks for the bank, such as counterparty, legal or reputational risk, that would outweigh the benefits of the risk transfer; and

(e) be commensurate with the amount of capital relief sought by the bank and must not entail any excessive risk transfer or risk retention.

Use Case for Irish SPVs

Ireland has a favourable legal and tax framework which allows for the creation of flexible and efficient SPVs that can isolate the assets and liabilities of the SRT transaction from the originator and other creditors whilst ensuring no double-taxation arises and the structure is tax-neutral at the Irish level of the transaction.

In addition, Irish SPVs offer a high degree of operational flexibility for SRT transactions, as they can be tailored to suit the specific needs and preferences of the parties involved depending on the nature and purpose of the transaction. Different types of instruments, such as notes or derivatives, can be used to transfer the credit risk and a wide range of assets including loans, mortgages, leases or receivables can be securitised or synthetically referenced. Moreover, Irish SPVs can incorporate various features and mechanisms, such as tranching, subordination, credit enhancement or triggers to allocate and mitigate the credit risk.

Some recent examples of significant SRT transactions structured using an Irish SPV include the following:

(a) a funded credit default swap between an SPV and an institution funded in turn by an underwritten issuance of credit-linked notes by the SPV;

(b) a funded financial guarantee with an SPV guarantor pursuant to credit-linked notes to fund obligations under the guarantee; and

[3] (Regulation (EU) 2017/2401 dated 12 December 2017, amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms as amended by Regulation (EU) 2021/558 of 31 March 2021)

(c) a credit-linked note issuance over a pool of car loans and leases.

The scope for the use of Irish SPVs was significantly expanded when the simple, transparent and standardised ("STS") securitisation regime was expanded in 2021 to include SRT transactions. As a result, we have seen an increase in the number of SRT transactions using an Irish SPV issuer and we expect this trend to continue given the attractiveness of Irish SPVs for major UK banks when securitising assets on a cross-jurisdictional basis.

Using an ICAV for SRT Investments

For clients who require a regulated investment fund vehicle in the overall investment structure, the ICAV has proved a popular option. Typically, we are seeing the SRT investment strategy overlapping with other banking and insurance-related investment strategies in the same ICAV.

An ICAV may also hold the SRT debt securities directly or indirectly through other entities or special purpose vehicles, such as an Irish SPV.

The ICAV has worked as a regulated vehicle of choice for the asset class in part because no Irish taxation arises on income or gains at the level of the ICAV. An ICAV may elect to "check the box" and be treated as a pass-through entity for US federal tax purposes, which has encouraged growth in the use of the ICAV by the US market. The popularity of the ICAV in that market, coupled with the fact the majority of banks with SRT opportunities are based in Europe, has accelerated the growth of the asset class this year and we expect to see this continue.

If you would like further information please liaise with your usual Maples Group contact or:

Dublin

Stephen McLoughlin
+353 1 619 2736
stephen.mcloughlin@maples.com

Callaghan Kennedy
+353 1 619 2716
callaghan.kennedy@maples.com

Ian Conlon
+353 1 619 2714
ian.conlon@maples.com

Joe O'Neill
+353 86 047 1671
joe.o'neill@maples.com

Cayman Islands

Pádraig Brosnan
+1 345 814 5441
padraig.brosnan@maples.com

James Meehan
+1 345 814 5311
james.meehan@maples.com