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Primer on capital relief trades and specialty finance

What's driving the emergence of these transactions?

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- Increasing regulation and capital requirements are forcing banks to share risk with investors
- Both asset sales and synthetic credit relief transactions are viable solutions for banks looking to improve their capital and leverage ratios
- Structural drivers underpin a growing opportunity set for institutional investors

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested.

Why banks need capital

Banks hold equity (or equity-like) capital to account for unexpected losses resulting from banks' business operations. Expected losses, on the other hand, are covered by provisions or write-downs in the value of the 'impaired' assets. If loan assets in banks performed as per their expectations, banks would, in theory, never need equity capital since the income earned on the assets would exceed the income generated by its liabilities and leave a positive 'net interest margin' from which banks could pay running costs and have some excess left over for profit.

It would not make much financial sense to buy bonds or deposit money in a bank that lacked capital buffers, since if things do not turn out according to plan there would be no buffer in place to protect the depositors or bondholders from incurring losses. Banks raise capital to create that loss buffer to be able to acquire deposits and raise money from the bond market comfortably and cost effectively. Regulators have a vested interest in the amount of equity banks hold since taxpayers effectively 'insure' deposits and thus the more equity a bank holds, the better (up to a point).

The difference between regulatory and economic capital

When it comes to determining how much capital banks need to hold, there is, however, a difference between what the market (shareholders) may believe constitutes an adequate loss buffer (economic capital) and what the regulators may expect them to hold (regulatory capital). That is because the market wants to be sufficiently compensated for its capital, yet would not want the bank hold too much capital relative to the buffer that the depositors or bondholders may deem adequate.

The regulators are primarily concerned about wider financial stability and protecting depositors (and thus the taxpayer) from being on the hook for any losses generated by a bank in excess of the amount of equity capital it has. Since the experience of the financial crisis, in particular, regulators have been forced to think about ways in which to safeguard taxpayers so that they are protected from having to 'bail-out' faltering banks should governments or central banks be forced to step in again – an insolvent banking system is in no one's interests, after all.

The result has been that banks are now required to hold much more capital than an economic capital lens would suggest. Consequently, the same net interest margin is spread out over a larger amount of capital which results a lower return on equity. This problem is particularly acute in Europe, primarily because European banks collectively lack pricing discipline (due to too much competition), which they make up for by restricting credit underwriting. Despite having fundamentally good assets, banks find it difficult to earn an attractive return on equity and thereby find it difficult to attract continued support from shareholders.

How regulatory capital is calculated

Regulators calculate regulatory capital by assigning a 'risk weight' to every loan asset. To illustrate, government bonds may have a risk weight of zero whereas investments deemed particularly risky – such as owning stocks – may attract a risk weight of 250%, in comparison. The aggregate risk weights are translated into a capital requirement by having the banks hold capital equal to a percentage, for example 10%, of its risk-weighted assets.

Post-crisis, the regulators came up with more measures to decide how much capital banks should hold and through which measure. One measure they came up with was the aggregate size of the balance sheet. This even requires a bank to hold capital against government bonds despite them being 'risk-free' in the sense of attracting a risk weight of zero. Capital calculated via this gross balance sheet measure is referred to as the 'leverage ratio', since it essentially looks at the bank's overall capital divided by the balance sheet size, unadjusted for risk. In addition, banks have to hold capital against other risks, including operational risk, interest rate risk, etc.

Most bank lending is not very risky in reality, and by making the provision of credit even more restrictive, it is becoming even less risky, economically. However, the amount of regulatory capital a bank needs to hold is determined by the weakest link – ie the measure that would require the most amount of capital to be held in the regulator's eyes. And, because the regulatory authorities are prone to further increasing capital requirements, banks maintain a buffer over and above the regulatory minimum. Banks are all too aware that falling below this minimum would have negative consequences for the bank's management as well as its stock price, with Europe's banks subject to regular stress tests performed by the European Banking Authority.

Given there is no political or regulatory will to relax capital standards any time soon, banks have to look for alternative solutions to raising potentially dilutive new equity capital from the stock markets, say through a rights issue.

Why both asset sales and synthetic transactions are viable solutions for banks

A bank that sold everything it originated would find itself with no income and very little capital. While it may make profits on asset sales, it is unlikely to earn enough or grow to be an established player in a competitive banking environment. as the size of the balance sheet would be too small for the liking of its shareholders.

Furthermore, it would be difficult for customers, particularly corporate customers, to develop strong relationships and build trust with such a bank either. Retail customers also value the relationships they have with banks, albeit to a lesser degree, since their interaction with a bank is typically for their current accounts. Individual customers take out loans infrequently and this limits their need for interaction, unlike a small business that needs to go to their bank regularly for working capital, factoring receipts, or a loan to expand the business, for instance.

Conversely, if a bank held on to every asset it originated it could become systemically very large and potentially very unwieldy. This would make the regulators even more nervous, since worse than a bank failing, is a big bank becoming insolvent. To reduce the systemic risk posed by the largest banks, regulators place additional capital surcharges on banks that become, by definition, "too big to fail" – requiring them to maintain a higher capital level compared to other banks. In this regard, big is measured by the size of the balance sheet, not its perceived risk.

Successful banks try to find a healthy balance between selling everything and selling nothing. Banks can manage their capital by:

- Dynamically adjusting the size of their balance sheets by selling assets from time to time;
- Restricting the amount of loans it makes relative to the amount of loans that are maturing, ie shrinking the balance sheet, or;
- Reducing its risk-weighted assets by buying first-loss credit protection on the assets, in a manner that the regulator considers sufficiently risk bearing to allow the banks to hold less capital as determined by the risk weight measure – but, crucially, not by other measures since buying credit protection does not reduce the size of the balance sheet.

Equity analysts also tend to look beyond credit protection trades after reaching a certain threshold, while regulators themselves would take a dim view of a bank that does too much of this type of credit risk 'hedging', since it is, by its nature, not completely risk eliminating.

A well-managed bank, nevertheless, is run taking all metrics into account, just as a good corporate Chief Executive does not narrowly focus on revenues at the expense of profits, or costs at the price of growth.

What options are available to banks?

1. Sell some assets

The good news is that banks do not necessarily need to hold on to all the low-risk assets they originate. They still can earn a healthy margin over and above the losses they expect on them. So, if banks can move these assets away from the balance sheet, there would be plenty of willing takers. From a buyer's perspective, owning low-risk mortgages, that on a loss-adjusted basis have consistently outperformed other low-risk investments – corporate bonds, for example – is an attractive proposition.

This is a great situation for banks and non-bank investors alike. Banks can originate these loans to the same exacting standards as the regulators demand and, from time to time, free up some capacity to do more lending by selling some assets to non-bank partners. Importantly, banks can still maintain the customer relationships and service the assets. The benefit of selling assets is that most of the metrics that cause the banks to hold capital in the first place – leverage ratio, risk weight, operational risk, interest rate risk et al – are overcome.

This is the cleanest outcome for a bank from a capital management standpoint. For low-risk assets, such as residential mortgages or certain types of retail loans, where the 'leverage ratio' measure determines the capital requirement, selling them is the only logical way to reduce their capital position. The emergence of these transactions has given rise to specialty finance strategies.

One other consideration is what the buyers of the assets that are sold can do with them. When we are considering these transactions, we are looking to buy assets that we can finance cost effectively through long-term financing. Consumer loans and mortgages are popular among lenders since they can analyse them statistically (large numbers of small homogenous loans). It is harder to analyse and lend against portfolios comprising of a comparatively small number of relatively large corporate loans or commercial real estate loans since they tend to be very different from one another. So, low-risk assets that allow a greater level of granularity tend to be better suited for asset sales. Banks can achieve a good price for them, buyers like to buy them and financiers like to finance them. Importantly, selling such assets also helps banks reduce capital on most, if not all, measures.

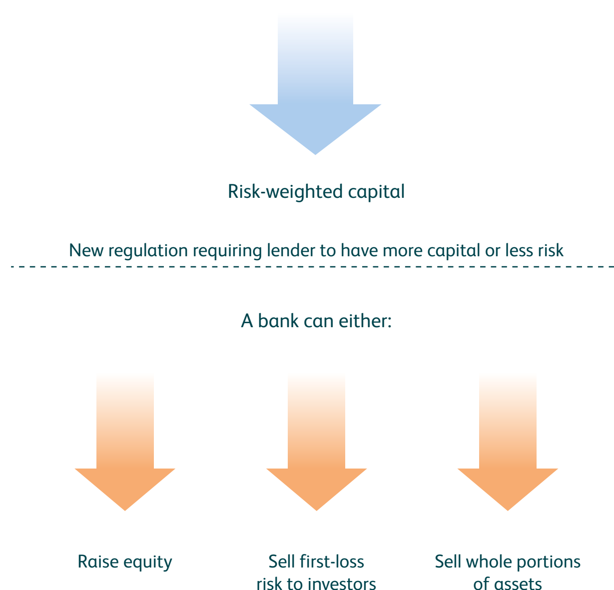
2. Buy loss protection on assets

The downside to selling assets is that the bank also loses the ongoing interest income earned on the assets. This reality inherently imposes a constraint on what types of assets a bank could sell. The types of assets that a bank cannot sell for practical or reputational reasons – overdraft facilities, undrawn revolvers, for example – are therefore better suited to synthetic Capital Relief Transactions (CRT). The primary reasons for banks to synthetically transfer the credit risk they originated are that they can improve their capital ratios and benefit from capital relief without selling assets. These transactions are termed 'synthetic' because the assets are not actually sold by the originating bank, only referenced, and stay on the bank's balance sheet.

Capital relief and risk sharing transactions are a good solution for desirable, but often difficult to source, asset types, such as SME lending and large corporate loan exposures. This approach is also the only viable solution for capital management purposes for asset types where, due to their nature, it is harder to assume ownership outside of the banking system.

How banks can improve their capital and leverage ratios

Banks lending creates 'risk assets' with an associated capital requirement



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How does this create opportunities for investors?

Investors can acquire exposure to bank assets either through direct means (owning the assets) or indirectly by selling credit protection via CRT. Clearly, a bank is likely to prefer to sell some assets more than others, because selling some assets is likely to be more efficient from a capital standpoint or feasible from a practical and commercial standpoint.

Asset availability and investment opportunities

European banks have €40 trillion of assets and earn, on average, 4% to 5% return on equity. This provides a wealth of opportunities for banks and investors alike. The aggregate amount of capital that has been raised for either buying assets or investing in CRT to date is a fraction of the total capital needs of European banks on an ongoing basis. This is not a fleeting opportunity, but a structural one. Both of these options form part of the capital management toolkit for banks, but serve slightly different purposes.

This need for capital relief, in turn, provides an attractive and enduring investment opportunity for well-resourced and sophisticated institutional investors who are able to gain detailed insight into the portfolios they seek to acquire.

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