Synthetic NPLs gain traction

The ECB's latest non-performing loan provisioning guidelines are expected to trigger increased synthetic NPL securitisation issuance. Nevertheless, defining a credit event for a portfolio of loans that are already non-performing remains a significant challenge.

The ECB guidelines prescribe full provisioning for unsecured NPLs after two years and seven years for secured NPLs. "This could potentially incentivise banks to offload the provisioning increase through synthetic structures," says Gordon Kerr, head of European structured finance research at DBRS.

The guidelines apply to significant institutions directly supervised by the ECB and cover all exposures classified as non-performing, as of 1 April 2018. Banks are required to inform the central bank of any differences between their practices and the prudential provisioning expectations from early 2021 onwards (for year-end 2020).

Full provisioning for secured loans will be phased out over a longer period, the goal being to allow banks to explore other options for resolving their NPLs. Furthermore, any partial write-offs made since the most recent NPE classification can be considered as provisioning and contribute to the coverage ratio of the bank.

Currently, synthetic NPL securitisations are executed for capital relief purposes and typically reference mixed and re-performing portfolios of corporates and SMEs. Italian transactions, in particular, tend to reference secured and unsecured SME loans. The asset class is gaining investor interest in Greece and Portugal too.

"SME NPLs are the hardest to sell, as they have features of both retail and corporate NPLs," says Tom McAleese, md at Alvarez and Marsal. "SME NPLs require a volume solution like retail, but they are also 'live' trading businesses, requiring data analysis like corporates. Investors have shied away to date from SMEs, primarily for servicing and granular analysis reasons."

He continues: "Synthetics, on the other hand, can remove the servicing challenge, with the bank maintaining the customer relationships and individual underwriting."

Although driven by different motives, synthetic NPLs feature similarities with cash deals and outrights sales. Cashflow modelling, for instance, does not differ in any substantive way from outright sales.

"It depends very much on the jurisdiction, but we typically look at the bankruptcy framework and the quality of the servicer," observes Kanav Kalia, director at Oxane Partners.

However, the main impediment to future issuance is defining a credit event for a portfolio of loans that are already non-performing. Credit event definitions would vary from deal to deal;

however, market sources have seen a number of transactions based on NPL recovery thresholds and restructuring credit events.

Although using recovery thresholds is understandable, the case for restructuring credit events seems less so. "Restructuring credit events don't make sense, since loans would have already been worked out for years, so there is basically no further restructuring," states Alessio Pignataro, svp at DBRS.

He continues: "The idea is to remove it from bank balance sheets, not to keep it - especially if the portfolio has been written down to zero - so it would make sense to sell it. There might be a residual pick-up if they are kept on balance sheet, but recoveries might fail."

Another challenge for banks is justifying such actions to regulators. Carlos Silva, svp at DBRS, adds: "Banks and regulators have a framework in terms of looking at PDs and risk weights and the benefit they get from a risk exposure, but this applies only to performing assets. They would have to justify this to regulators. Nothing has been calibrated for defaulted exposures."

However, he suggests that the situation is different if banks can justify significant risk transfer. "It will all depend on the regulatory capital relief they can get."

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