

## StanChart brings reg cap deals into the light

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**Standard Chartered transferred the credit risk on a \$3bn revolving pool of emerging markets trade receivables using its Sealane II securitisation this week. It was a rare example of the intensely private regulatory capital relief market moving into public markets, but one that could become much more common — partly as the result of rules unique to the UK but also as banks everywhere deal with higher risk weightings and capital requirements.**

The deal was one of the first to have a public rating — a result of strict new Financial Services Authority rules — and was publicly marketed and widely distributed.

The FSA guidance, introduced in June, means that UK banks have to get their deals rated in order to get capital relief. And growing investor interest in the juicy returns — Sealane II offered 14% — means more public distribution.

Until now, trades have typically been unrated and bilaterally negotiated deals between large investors and specific banks. Hedge fund Christofferson Robb is probably the best known investor in this area, but other institutional buyers including Dutch firms PGGM and APG are also active.

"Throughout the financial crisis we've done private, reverse-enquiry deals in similar ticket sizes," said Paul Hare, global head of portfolio management at Standard Chartered in Singapore. "But this is very much a public deal, it is widely held, and we had a number of new investors participating, as well as some that were in other START [Standard Chartered's corporate loan CLO programme] or Sealane deals."

The bank marketed the deal for about four weeks, starting when the FSA guidance became clear. The effort paid off with greater volume, allowing Standard Chartered to get capital relief on a \$3bn portfolio rather than the \$2.5bn portfolio it began with. Even at the larger size, it was still oversubscribed.

"A larger deal which was still oversubscribed is a positive statement about the structure, the trade finance product, and about how people perceive the economic opportunities in Asia," said Hare.

However, forcing issuers to get their deals rated, instead of allowing them to use the Supervisory Formula Method (SFM) — an internal model-based approach — remains controversial. Even after Sealane II, Standard Chartered wants to see the FSA soften its stance.

"As a long term solution, we'd prefer to see a formulaic approach reinstated alongside the ratings-based approach," said Paul Hare. "It may not be practical to rely 100% on the rating agencies for all variants of securitisation."

But forcing capital relief trades to get rated also means opening the market to public activity.

"It's unlikely to develop into a full traded secondary market, but things will gradually become more public, and distribution will be wider," said Daniel Watkins of advisory firm Green Street Capital. "More funds will start to recognise this niche, and banks won't just rely on private placements with specific investors."

He said that banks had more certainty about the future of the regulatory environment and had dealt with their most profound capital problems.

"I'd expect to see more capital-driven securitisations coming, as banks struggle with tougher risk-weightings and higher capital requirements," he said. "Banks can afford to pay to get these done, because the benefits of relief will be so much greater than in the past. Certain assets are becoming more capital-intensive, banks need to hold more capital, and will need to pay more for capital. It's a three-pronged cost spiral."

Others disagree. "Investors who want to do synthetic capital relief trades are typically hedge funds or private equity, given the risk transferred is usually equity or mezzanine," said Jean-Baptiste Thiery, head of FI securitisation in EMEA at Natixis. "Sometimes, given market conditions, they have a return target above a bank's cost of equity, so it can be hard to find investors at the right price to take on risk transfer."

### Rating requirements

The FSA's new guidance on demonstrating risk transfer means that if a bank wants to sell equity or mezzanine risk in a particular portfolio, it must get a rating on part of the portfolio it still holds — to prove that the riskiest parts have indeed been sold.

Standard Chartered sold the tranche of risk from 1% to 7% losses into the market via an unrated credit-linked note, and issued a CDS contract between two Standard Chartered entities for the exposures between 7% and 16%. It is that CDS that has been rated.

"Our ratings address the credit risk associated with an actual instrument — a contract with definite terms and conditions can clearly state what our rating is measuring," said Kan Leung, the Moody's analyst that rated Sealane II. "In this case, both the counterparties are Standard Chartered entities, so economically the risk stays with the group."

Until the new FSA guidance came in this June, banks that were allowed to use the internal ratings based approach to calculate their capital requirements (in effect, all large banks) used the SFM to demonstrate risk transfer.

The method allows banks to model risk in their own portfolios, once regulators have signed off the model, and usually allowed banks to benefit compared with a standardised rating-based approach.

The FSA's logic for the change was that "the Supervisory Formula Method will very often fail to appropriately capture the risks in retained securitisation positions". In other words, a bank would be able to claim capital relief cheaply, because it had not actually transferred much risk to the market — and therefore had to pay very little to obtain protection.

Market participants objected, arguing that as the FSA signed off bank internal models, the appropriate response was to get better at signing off models, rather than relying on ratings.

Olivier Renault of StormHarbour Securities said: "Rating agencies may not be able to judge a loan portfolio as well as the originating bank. In any case, if the SFM is too lenient, why not simply tweak the formula?"

A response to the FSA's consultation, which took input from some UK banks, also queried why the FSA did not simply change the SFM, and asked whether other regulatory initiatives were discussing changing the inputs to the models used.

The European Commission's recent draft of the Capital Requirements Directive (CRD IV) seems to leave the FSA out on a limb. The document, released in late July, said: "Institutions should take appropriate steps to develop and use internal models for calculating own funds requirements."

However, this provision sits in the directive part of the CRD IV draft, meaning the FSA will choose how to implement it. The tougher regulation elements have to be implemented unaltered.

## **Selling Sealane**

Standard Chartered opted to sell credit risk on 90-day trade receivables with Sealane, which are effectively short term corporate loans. The average rating of the exposures was B2/B3, based on a mapping from Standard Chartered's internal ratings to Moody's.

Some 55% of the initial exposures are from Asia Pacific, with another 17% from the Indian subcontinent and 16% from the Middle East and North Africa. The strong EM focus helped the deal avoid wider market worries based on the eurozone sovereign crisis.

The short tenor of the exposures means that Sealane II is a revolving portfolio — Standard Chartered must replenish it with other trade receivables that meet the minimum criteria.

"The tenor works for us — it needs to be long enough to appeal to institutional demand, and to provide useful capital capacity for us to write new business," said Hare. "It would be impractical to do a new deal every 90 days, so we have structured the transaction as a term deal with a replenishable pool."

Moody's rates the portfolio according to the minimum criteria, reflecting the uncertainty of the exposures that would remain after the initial portfolio rolls off in three months time.

The retained rated tranches are an Aaa rated \$30m class 'A' covering 15%-16%, an A1 \$120m class 'B' covering 11%-15%, and an A3 rated \$120m class 'C' covering 7%-11%.

Standard Chartered sold a \$180m second loss tranche covering the risk from 1% to 7%. The bank retained the unrated 0%-1% first loss.

The bank offered a coupon of 14% above three month Libor for the distributed tranche of Sealane II. While that might appear to be close to many banks' cost of equity, on a tax-deductible basis it is likely well below Standard Chartered's return on equity target of the mid-teens.

## **Owen Sanderson**