Synthetic, but How Much Risk Transfer?

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The views expressed in this paper are our own and do not necessarily coincide with those of Bank of Italy

Summary

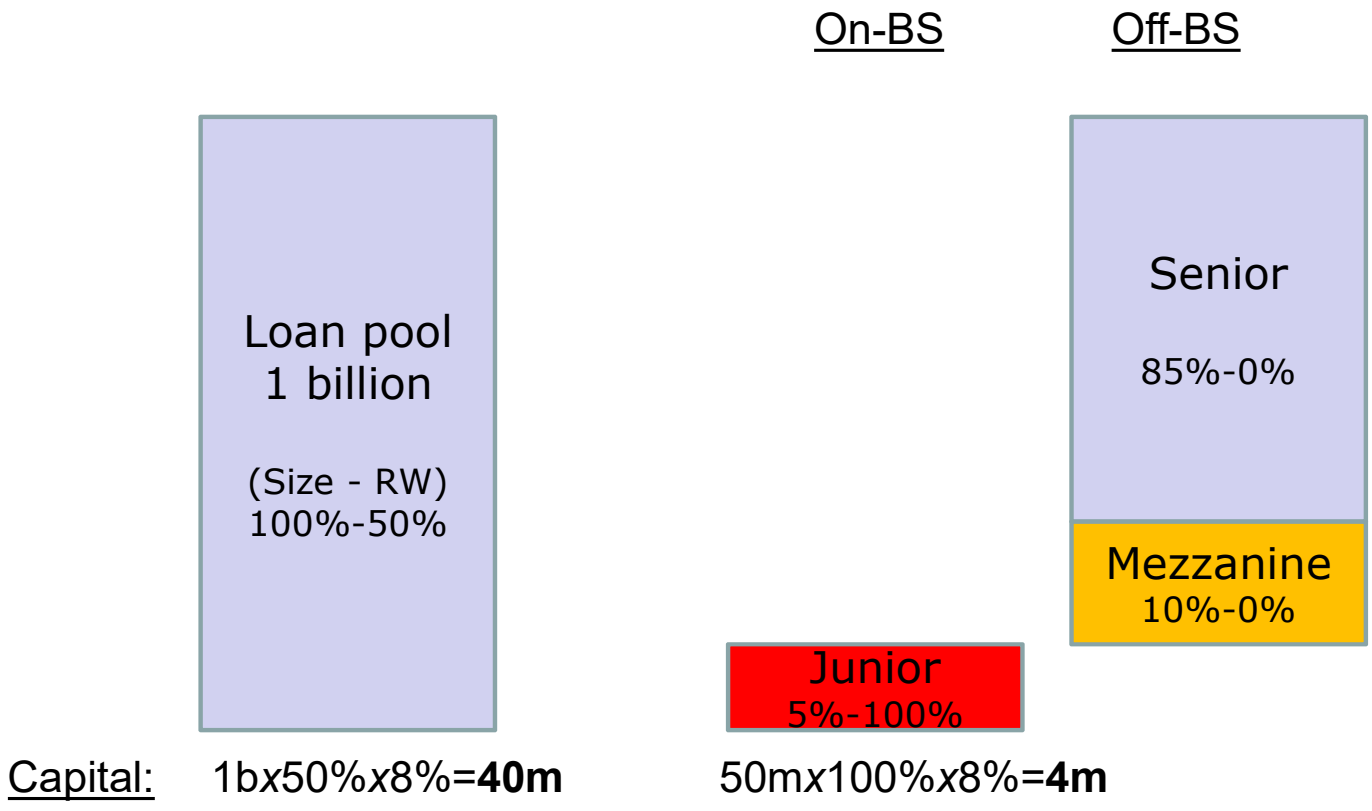
This paper

- Synthetic securitization market rapidly growing in EU
- First contribution to potential financial stability implications:
  - Increase in bank leverage
  - Reduction in monitoring of transferred loans
  - Part of the transferred risk remains in banking sector

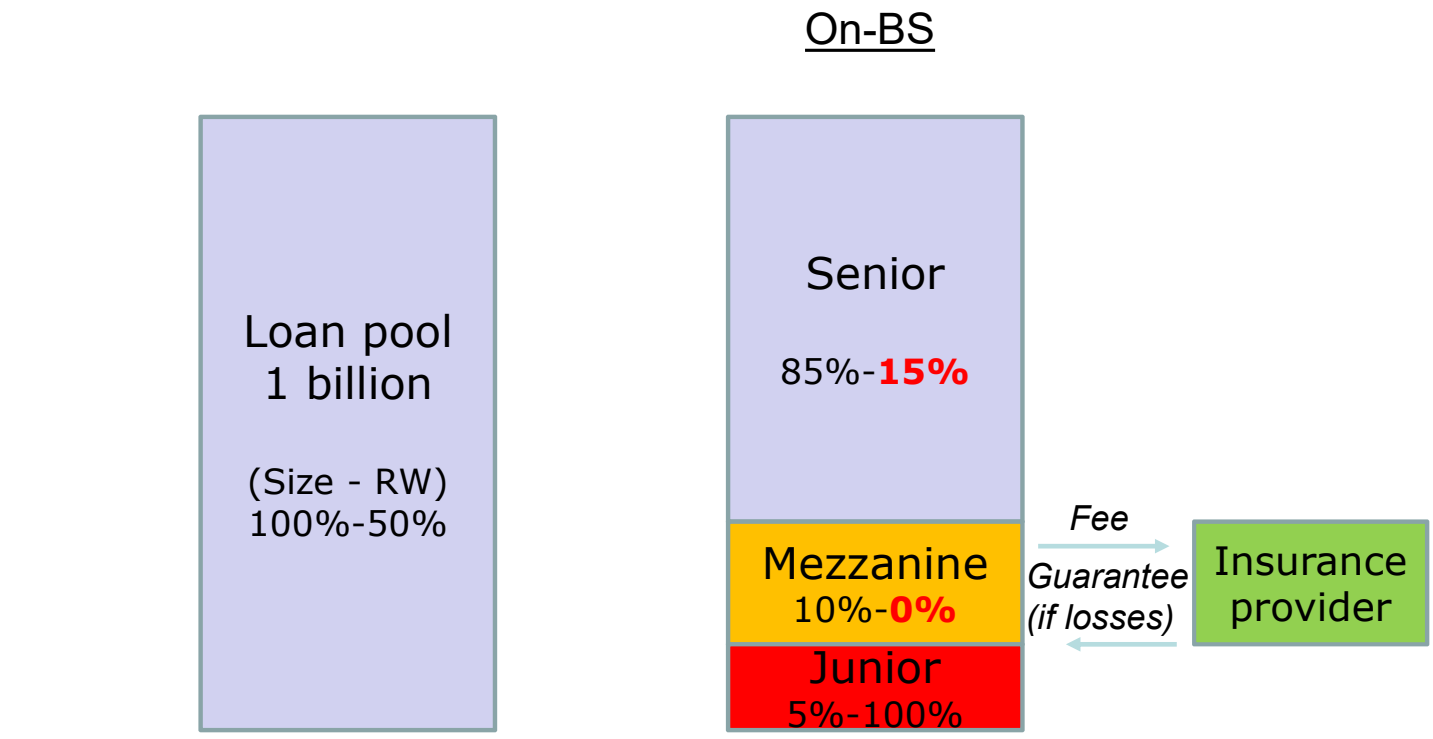
My discussion

- Description of the market & regulatory environment
- Comments on main results

Traditional securitization (*off-balance sheet*)



Synthetic securitization (*on-balance sheet*)



Capital: 1b*x*50%*x*8%=**40m** 4m+850m*x*15%*x*8%=**14.2m**

Synthetic versus traditional securitization

Synthetic sec. directly exposes to some additional risks vis a vis traditional

- Senior tranche:
  - $RW > 0$ account for them
  - but, $RW \uparrow$ as losses materialize $\rightarrow$*procyclicality*
  - complexity & opacity upon bad shocks$\rightarrow$ *funding problems* in crises
- Mezzanine tranche:
  - Counterparty risk$\rightarrow$ *interconnection*
  - Mitigated if insurer provides high quality collateral
    - Requirement to benefit from zero RW for private insurers

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Synthetic sec. could indirectly create/mitgate risks vis a vis traditional through many potential differential effects channels

- Lending & risk-taking
- Screening & monitoring
- Interconnectin with non-banks (explicit and implicit)

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General comment: paper can have two objectives

1. Highlight similarities $\rightarrow$ interesting
2. Highlight/identify differences $\rightarrow$ more interesting!!

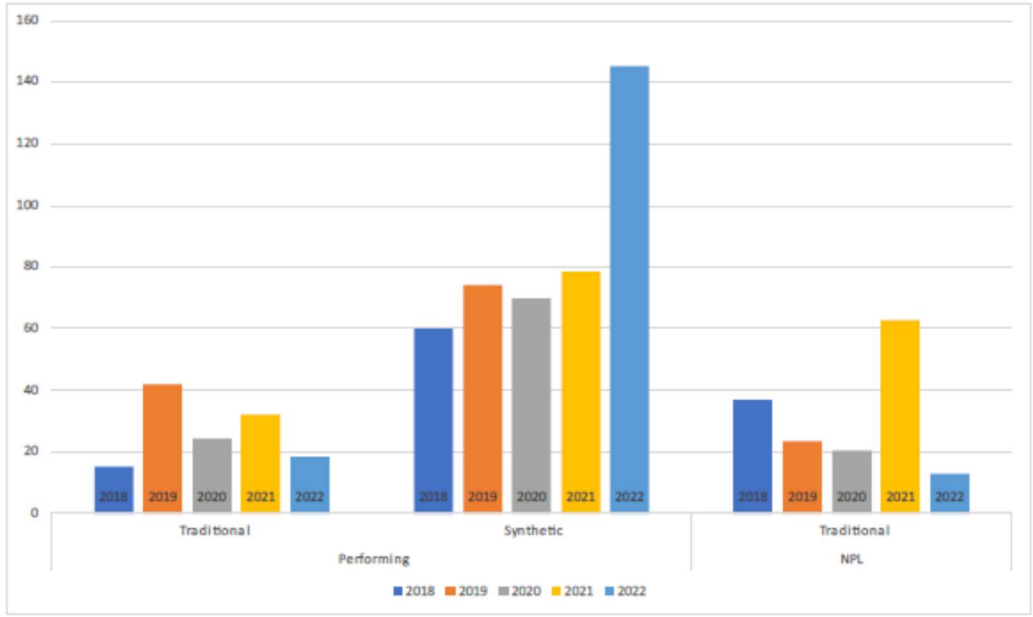
Securitization market in EU

- Significant Risk Transfer transaction volumes
  - Traditional & synthetic securitization benefiting from capital relief

SRT transaction volume per year

Notional amount of performing SRT transactions

(EUR billions)



Source: ECB data.

$\Rightarrow$ Extension of Simple, Transparent, Standard regime to synthetic sec. in 2021
  - Additional capital relief benefits: larger senior tranche & lower *RW*

- Market keeps on growing but remains small
  - Overall capital relief 2018-2022 below 0.5% of total capital

Comments: Synthetic securitization and lending (I)

Finding: synthetic securitization associated with leverage & lending expansion

- Intended effect of policies supporting securitization
- Consistent with evidence that traditional securitization supports lending

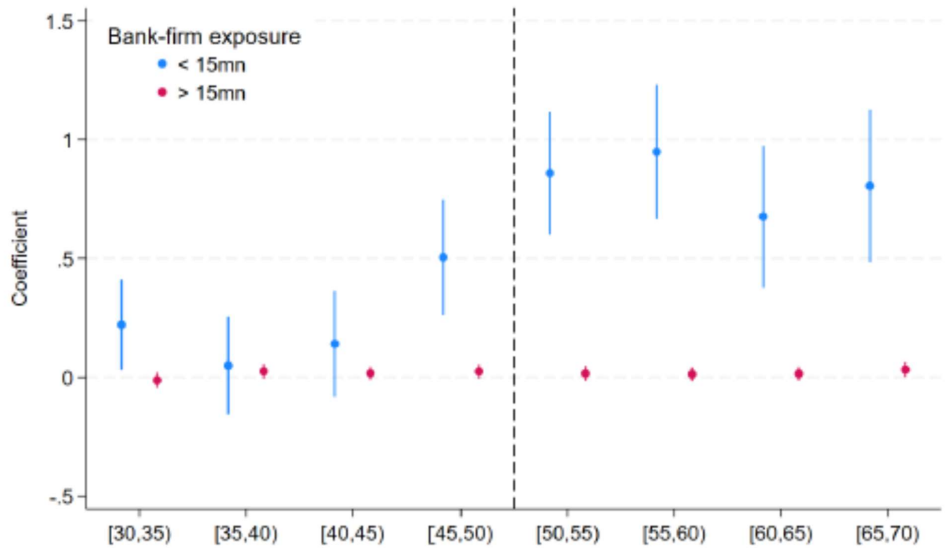
$\Rightarrow$ **Compare lending expansion implied by synthetic vs traditional securitization**

- Can a notion of *capital relief lending multiplier* be estimated across the two securitization types?
- Is synthetic securitization less expansionary? Why?
  - Banks hold aggregate risk exposure in retained senior tranches
  - Could make them more reluctant to use capital released from mezzanine tranche

Comments: Synthetic securitization and lending (II)

Finding: banks securitize synthetically capital expensive loans:

- Jump in securitization prob. for low exposure firms with revenues $> 50m$ (blue)
  - Largest discontinuity in cap req from SME cap support factor at revenue threshold



- Inconsistent with $< 50m$ revenues low exposure firms higher securitization prob. than high exposure firms (blue vs red)
  - Former loans less capital expensive due to SME cap supp factor

$\Rightarrow$ Explore **role of relationship lending** in securitization decision

Comments: Synthetic securitization and lending (III)

Finding: synthetic sec. allows banks to further exploit SME supp. factor

- Part of capital relief from securitization of capital expensive loans used to issue capital cheap loans benefiting from SME supp. factor
- But, estimate of $7b€$ additional exploit SME supp factor seems upper bound...
- Back of the envelope estimation of upper bound on additional exploit:
  - SRT securitization in 2023: $250b€$
  - Capital relief upper bound: $250b€$ x 100% x 8% $= 20b€$
  - Maximum capital relief for SMEs: $24\% = 100\% - 76\%$
  - Increase in exploit of SME support factor is maximum if
    - *No* securitized loans benefited from SME supp factor
    - *All* lending from capital relief to SMEs with maximum capital relief

$$\text{Increase in exploit SME supp factor} < \underbrace{20b€}_{\text{SRT Cap Relief upper bound}} \text{ x } \underbrace{24\%}_{\text{SME capital relief upper bound}} = 5.2b€$$

- Upper bound of $5.2b€$ is below paper estimate of $7b€$...
- Potential risks associated with too much reliance on SME supp factor seem overstated

Comments: Synthetic securitization and monitoring

Finding: synthetic securitization leads to a reduction in monitoring

- Use of novel proxy for monitoring: PD update frequency
  - PD update frequency contributes to explaining one-year ahead realized default
- PD update frequency falls for synth. securitized loans relative to
  - Non-securitized loans by same bank to other firms
  - Non-securitized loans by other banks to the same firm
- But, PD updating could fall because transferred loans are less risky:
  - Investors providing insurance could screen loans
  - Securitizing bank could learn from investors' selection

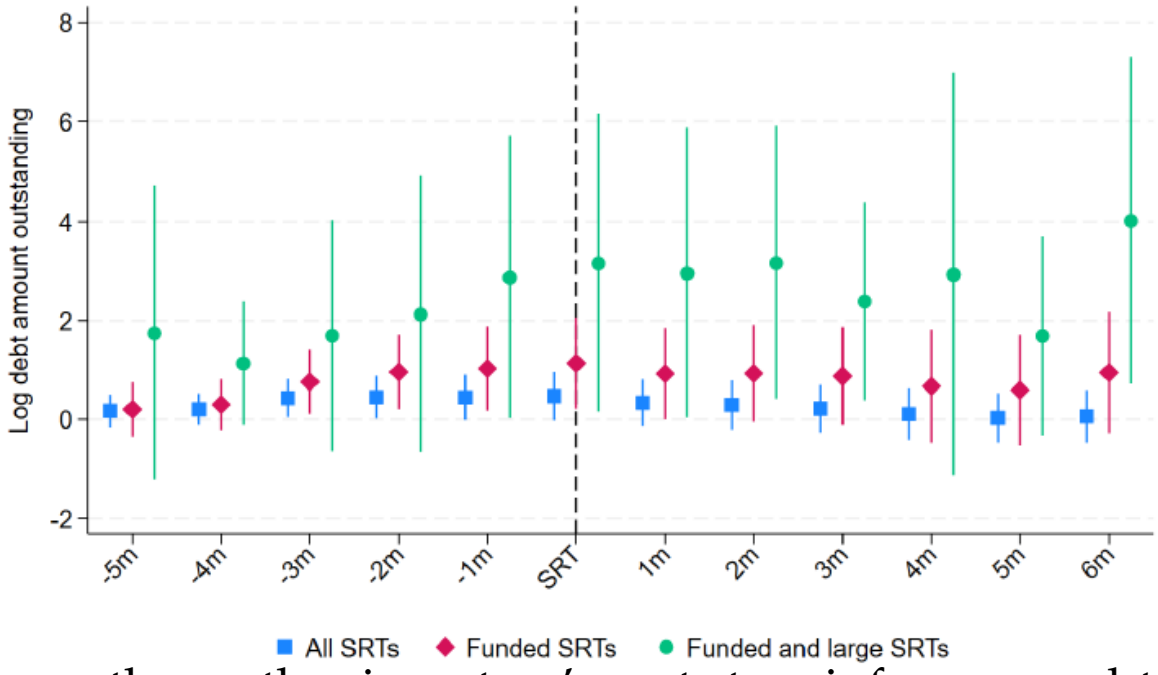
$\Rightarrow$ **Supplement finding with analysis of**

- Realized defaults
- Potential disciplinary role of private versus public providers of insurance

Comments: Synthetic securitization and risk-transfer

Finding: insurance provision partially funded by the banking sector

- Banking sector loans to investors in SRTs increase ahead of the transaction
  - $\Rightarrow$ Not all transferred risk actually transferred outside banking sector



- $\Rightarrow$ Control for growth on other investors' assets to reinforce round-tripping argument

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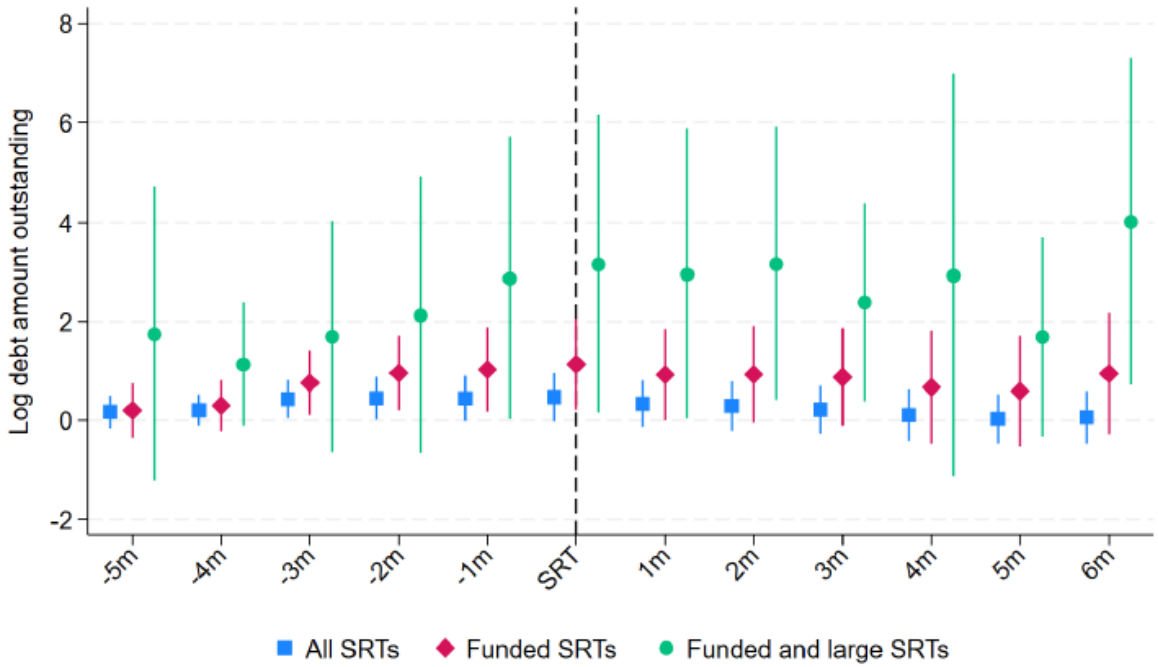

- ⇒ Control for growth on other investors' assets to reinforce round-tripping argument

Avenue for analysis on effective risk-transfer: implicit support

- Reputational risk could lead to support mezzanine insurance investors
- Stigma concerns similar to those for suspension of payments on AT1 capital

Conclusion

- First academic contribution to market with growing importance
- Evidence synthetic and traditional securitization works similarly
  - Lending, monitoring, interconnection
- Highlight dimensions make synthetic securitization *special* from financial stability perspective
- Looking forward to next version!