

Significant Risk Transfers, Basel IV and Irish SPVs in 2024

Insights - 14/12/2023

The European Significant Risk Transfer (SRT) market is well established and involves the transfer of credit risk from a bank's portfolio of assets to a third party, such as a special purpose vehicle or insurer. It is well accepted that financial markets are likely to see an expansion in SRT activity as Basel IV takes effect.

The purpose of this article to serve as a high level refresher on:

- what are SRT transactions?
- why are we are likely to see an increase in SRT transactions in the coming years?
- how Irish SPVs (Special Purpose Vehicles) can be used in SRT transactions?

Significant Risk Transfer transactions explained

As a preliminary point, it is important to remember that how much capital a bank must hold under Capital Requirements Regulation (CRR) is determined by, amongst other things, the risk weighted assets (RWAs) that the bank holds. SRT gives banks a method for deleveraging their balance sheets by reducing its RWAs and obtaining capital relief as a result. An example of this balance sheet optimisation would be a bank transferring the risk of a tranche of a portfolio of loans to an investor or an SPV funded by an investor.

Clearly, SRT transactions serve as a crucial tool for banks, enabling them to liberate capital and enhance balance sheet capacity. The freed-up resources can then be directed towards new lending activities and more generally, contributing to the deployment of capital in more profitable lending projects.

SRT transactions can take on various forms including true sale or synthetic securitisations, credit derivatives or guarantees. The selection of a particular structure hinges on several considerations,

including the nature and calibre of assets, regulatory implications, prevailing market conditions, and the cost and accessibility of funding. The appeal of SRT transactions for banks lies in their versatility, as they can involve both performing and non-performing assets. Notably, synthetic SRT transactions are prevalent in the realm of performing assets, while SRT transactions involving Non-Performing Loans (**NPL**) typically take the form of cash transactions.

The European legal framework for the use of SRT transactions as a capital relief tool is provided by the CRR, in particular:

- Article 243 on the Criteria for STS securitisations qualifying for differentiated capital treatment
- Article 244 on Traditional Securitisation
- Article 245 on Synthetic Securitisation

These guidelines outline the criteria for assessing and supervising SRT transactions, encompassing the verification of risk transfer, identification of both the originator and investor, and ongoing monitoring of transaction performance.

Why are we likely to see an increase in SRT transactions in the coming years?

The principal objective of Regulation (EU) 2021/558 (**Basel IV**), the implementation of which began earlier this year at the start of 2023, was to "restore credibility in the calculation of RWAs and to improve the comparability of banks' capital ratios". Some of the key outcomes of Basel IV include:

- enhancing the standardised approaches for credit risk, credit valuation adjustment risk in the context of derivative instruments, and operational risk, aiming to improve upon the standards established by earlier Basel accords
- measures to restrict the use of internal model approaches that certain banks employ to calculate their capital requirements
- the introduction of a leverage ratio buffer designed to impose further constraints on the leverage of globally systemically important banks. This new leverage ratio requires such banks to uphold additional capital reserves, enhancing their capacity to absorb losses and reinforcing the overall stability of the financial system
- the replacement of the existing output floor with a more risk-sensitive floor. This new rule will ultimately direct banks to maintain capital reserves equal to at least 72.5% of the amount indicated by the standardised model, regardless of what their internal model suggests

The cumulative impact of these changes is viewed as good news for the SRT markets as banks will

look to reduce their RWAs.

It should be noted that banks have five years to fully comply with the implementation of provisions and based on the current track record, it is possible that the deadline will be extended beyond five years.

The use of Irish SPVs in SRT transactions

While it is possible for an investor to enter a bilateral arrangement with a bank, it is common where there are multiple investors to fund an Irish SPV using what are known as Credit Linked Notes (**CLNs**). The bank initiating the transaction transfers the credit risk associated with the underlying exposures to the Irish SPV through a credit default swap or a financial guarantee/credit protection deed. The SPV, in turn, issues CLNs, thereby transferring the credit risk to the investors.

In this example, where a credit event linked to the portfolio occurs, a cash settlement is initiated from the SPV to the bank in accordance with the credit default swap. Concurrently, the remaining value of the CLNs is adjusted downward by an equivalent amount. The characteristics of CLNs provide flexibility as they can be listed, rated, and traded based on the specific preferences and requirements of investors. This adaptability allows for a diverse range of options in structuring and managing credit risk.

How can Ogier assist?

Coupled with our access to the global Ogier network and colleagues in jurisdictions such as Cayman, Jersey and Luxembourg, our full service offering in Dublin covers Irish legal and tax advice and a full suite of corporate administration services to SPVs including providing directors, registered address and statistical reporting. Ogier in Ireland is well placed to advise on all Irish aspects of SRT transactions.

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