EXPERT Q&A

Significant risk transfer is one of the most talked-about investment ideas in private debt. But greater investor education is necessary to maximise the benefits of such deals, says PAG partner James Parsons

SRTs step into the spotlight

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Q Can you start by explaining what a significant risk transfer deal is?

Significant risk transfer is a way for banks to reduce the regulatory capital requirements of holding loan portfolios on their balance sheet. It is also known as bank risk-sharing or regulatory capital relief.

How it works is, a bank buys credit protection on a specific loan portfolio on its balance sheet by paying a premium to a non-bank investor, which allows the bank to obtain a significant reduction in the capital required to support that portfolio. The loans stay on the bank's balance sheet, making this a really flexible transaction type that works across a range of loan product types.

Regulators accept this arrangement because it is a non-bank source of capital – for example, a private credit fund – writing the credit protection, since regulators' goal is to protect the banking system.

SRTs are typically written on a first loss basis up to a maximum amount equivalent to a percentage of the total loan portfolio size – this typically sits between 4 and 15 percent. The credit protection is written as a financial guarantee or a credit default swap, usually packaged into a credit linked note equivalent to the maximum exposure for the investor.

The investor pays for the note, receives a coupon over the life and, at maturity, receives the principal amount of the note back less any realised credit losses post-workout. So, the bank gets capital relief and the investor gets an attractive coupon.

Q What makes SRTs attractive to investors?

Because SRTs are based on a portfolio, like other forms of securitisation, any potential credit loss is incremental rather than binary. So, compared to making individual loans, these deals have attractive features from a risk-return perspective.

SRTs are also designed to cover excess unexpected losses on portfolios. Regulators want banks to have enough capital to survive unexpected loss events, like a market crash, and they are very conservative in their estimates. That conservatism is what enables banks to pay an attractive coupon on SRT deals.

Finally, SRTs allow investors to access different portfolio types, from leveraged loans through to subscription lines, giving them a choice based on their risk appetite. At PAG, we tend to target the more conservative loan types to create predictable income streams for our investors.

Q These deals have been around since at least 2007. Why are they making news now?

They have been around since this capital relief mechanism was embedded in the Basel II banking regulations. What has changed is that we have been through a period of benign loss rates that has attracted capital to private credit and, along with rising base rates, that has benefited SRTs.

For a variety of reasons, most US banks were not active in SRTs until 2020. Then last year saw the Basel III Endgame proposal from the US Federal Reserve and other agencies, which required a further capital increase for US banks, and the Fed outlined the structures US banks could use for capital relief through SRT. That has given banks and investors a clearer route forward on these deals. Given the scale of US banks' total assets, we expect a much larger volume of SRT issuance.

Q What is the relationship between SRT transactions and private credit?

In 2013, the Basel III bank capital accord doubled banks' minimum regulatory capital requirements, which was a major catalyst for the growth of both private credit and SRTs.

There are really two ways for investors to address the private debt opportunity today: firstly, by going around the banks and lending directly to companies, and secondly by going through the banks, which includes doing SRTs and related products.

A small number of specialist funds have been working in SRTs for some time. SRTs are quite relationship-driven mandates that address a number of issues around confidentiality, because banks do not want detail about their underlying loan strategies spread widely. Banks are also heavily focused on execution risk. We have also seen partnerships where the banks originate asset-backed loans or investment grade credits and pass them on to investors via SRTs, cash securitisations or whole loan sales. Conflicts can arise, however, when managers try to bypass banks to originate asset-backed loans or investment grade lending directly.

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Q How have you seen this market change over time?

We've invested in about $100 billion of underlying portfolios since I joined PAG seven years ago. I previously spent 10 years running the SRT fund at BlueCrest Capital, where we did the first of these deals back in 2007.

Since then, the most obvious change has been the growth of the market in absolute size, while we have also seen an increase in the range of banks and underlying loan portfolios coming to the market. Regulation has become more complex and is increasingly applied differently in different jurisdictions, which means the best opportunities are constantly evolving and SRT has matured into different specialisations around each manager's risk-return appetite.

Q What makes SRT different from other kinds of securitisations?

People tend to be more familiar with cash securitisations and collateralised loan obligations (CLO), but the key difference here is that, in SRTs, the loans stay on bank balance sheets and it is the banks that manage them.

That creates an information and management asymmetry with the investor, and SRT transactions therefore come with safeguards, such as provisions that the people in the bank managing the loans will not know which ones have credit protections.

Managers simply putting asset-backed security or CLO structures onto SRT transactions are often not clued up on these subtleties, so SRT specialists are needed.

Q What are your predictions for the development of SRTs moving forward?

Ultimately, SRT transactions square the circle between regulators' desire for banks to have high capital ratios and the need for banks to be able to lend affordably. The regulators in Europe support these deals given the high capital demands of the green transition and digital transformation, while the US has given the green light to SRTs to enable recycling of bank capital to support the real economy.

The SRT market is in good health, and we are expecting it to grow at a rate of 30-40 percent per annum moving forward. As the product gains more visibility, banks in other markets such as Asia are also likely to get more involved. ■