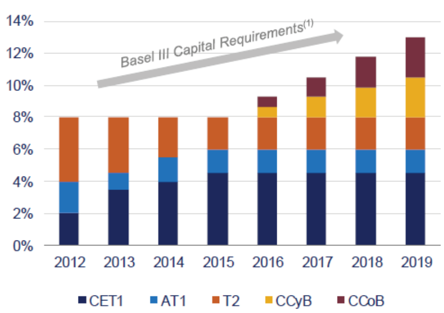
Banking on SRT

Jason Walker and William Murray reveal how regulatory capital transactions can provide diversification and attractive returns

Since the financial crisis banks have been under intense scrutiny, in particular from their regulators. Regulators have sought to ensure that banks are not only underwriting loans appropriately but also that they hold appropriate amounts of capital against the loans that are made.

The tightening of the regulatory environment continues. The next evolution of Basel IV will be enacted between 2022 and 2027. Furthermore, there are additional implications from changing accounting rules, such as IFRS9 and CECL. Banks need to keep adapting to an evolving regulatory landscape.

Banks' regulatory capital requirements continue to rise



Source: The New Basel III Framework: Navigating Changes in Bank Capital Management. PWC's FSI. October 2010. ARP Research.

As bank regulation evolves, regulatory capital transactions, officially termed as Significant Risk Transfer (SRT) by regulators, will be an important part of a bank's toolkit to manage their capital positions in addition to instruments such as AT1s, CoCos and Contingent Capital.

SRT transactions are another potential tool that help them manage their regulatory capital risk via risk sharing of the loans on their balance sheets with a range of institutional investors. SRTs can offer stable and low correlated returns. These transactions use well established securitisation technology. Unlike traditional securitisations, they are not driven by arbitrage motivations, but are risk sharing transactions where the bank and investors are closely aligned and both benefit in different ways.

What is the investment opportunity?
SRT provides an opportunity to work alongside banks, developing close relationships to understand and invest in their core lending businesses such as SME lending, mortgage lending and trade finance. This is a key differentiation of the SRT sector, whereby banks use SRT to allow them to retain attractive core lending exposures on their balance sheets to manage the capital of their ongoing core business operations where they have a significant market presence and wish to continue to do so. From an investor perspective this is interesting for i) the opportunity to gain access to otherwise difficult to source assets; ii) the ability to underwrite and understand the bank's core business; and iii) the close alignment of interest of bank and investor is an attractive component of the investment. Importantly, they allow an investor to share risk with a bank in its core loan portfolio, while isolating that investment from general bank risk.

The risk sharing and alignment components have contributed to strong credit performance of these transactions. This means that the risk-adjusted returns from SRT investments are attractive and compare favourably to competing opportunities in adjacent sectors. For example, income yields on an SRT transaction are typically 8-12 per cent, versus AT1s, which typically offer income yields of 4-6 per cent[1].

However, the sector is nuanced and the structures can be complex. Banks hold a wide variety of different asset types in a range of different jurisdictions. Add this to the nuances of the deal structuring and it becomes important to have the experience and knowledge to analyse and, importantly, differentiate between different deals in order to select the very best investments and to seek to achieve the best risk-adjusted returns.

The SRT market is evolving and growing – an attractive entry point
The regulatory scrutiny of banks continues. This is driving more changes as to how banks will manage their regulatory capital. SRT is an important element of how they manage this challenge and is firmly embedded in their business process. In the coming months and years we will see more banks issuing SRT deals and, as the regulatory rules change, banks will use a wider range of asset types. SRT deals are evolving to meet these demands and regulatory rule changes, resulting in yet more types of SRT deals to consider, thereby increasing investment opportunities. Investors equipped with the expertise and knowledge to consider the SRT sector have the opportunity to access attractive, stable, risk-adjusted returns that exhibit low correlation to wider markets and could provide an attractive income producing profile to their portfolio.

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In association with CQS

[1] Source: CQS research