

Synthetic Risk Transfer: An Appealing Opportunity for Banks and Credit Investors

AUTHORS



Mark Kruzel
Senior Vice President,
Capital Markets



Kris Kraus
Portfolio Manager,
Private Special Situations



Vineet Agrawal
Portfolio Manager,
Private Special Situations



Jacques du Hamel de Breuil
Portfolio Manager,
Private Special Situations

Demystifying credit risk transfers and implications for the asset-backed finance universe

For the past 15 years, banks have been frequent issuers of risk transfer securities, colloquially termed synthetic risk transfers (SRT, also known as credit risk transfers). Historically, issuer interest in SRT was mostly in Europe and Canada, where the market has grown from a bespoke credit market to over \$20 billion of equity issuance annually. Up until 2023, these trades were noticeably absent from the U.S. market, but renewed pressure on balance sheets and high interest rates have driven increased demand. With over \$7 billion of SRT issuance in Q4 2023 alone¹, 2024 is slated to see record activity, with rapidly increasing adoption by U.S.-based global systemically important banks (GSIBs), regional banks, and community banks. Given today's uncertain economic environment and persistently high interest rates, we think SRT may be a useful tool for banks to manage their credit portfolios. For investors, SRT offers a new way to access to bank credit portfolios. This paper delves into the genesis of SRT transactions and examines why SRT may offer a compelling diversification opportunity for investors today.

Summary:

- SRT gains ground in the United States
- Setting the stage: SRT development under Basel III
- Risk transfer in the United States: Why now?
- How does SRT work?
- U.S. SRT market outlook and development
- Positioning the investor opportunity
- Conclusion

¹ As of March 2024. Source: PIMCO Capital Markets Estimates using data collected from bank annual reports, SEC & FDIC filings, and dialogue with law firms, banks and other market participants. Excludes transactions with multilateral development institutions.

SRT GAINS GROUND IN THE UNITED STATES

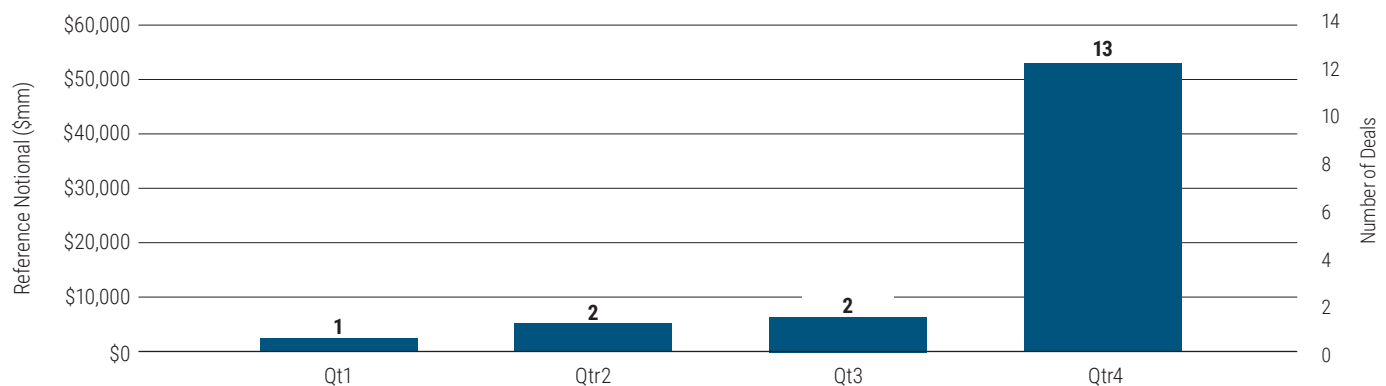
2023 was a disruptive year for banking, but the most lasting implication for U.S. banks won't be the regional bank failures in the spring, but rather investors' official embrace of a little-known tool from Europe called synthetic risk transfer (SRT)². Banks in Europe and Canada have long embraced SRT as a capital tool to buffer capital ratios and help mitigate credit risk, with over 100 transactions a year and aggregate assets referenced in structures exceeding \$250 billion per annum³. However, the United States was noticeably absent in that market, with only a handful of U.S. banks active in SRT. However, that changed in 2023, when in Q4 alone, there were nearly 15 various SRT transactions, with aggregate risk transfer of assets exceeding \$60 billion¹ – marking a significant shift. In fact, if Q4 2023's pace of SRT issuance

continues well into 2024, the United States will be on par to match European issuance levels by the end of the year.

Considering SRT's rapid rise in popularity in the United States, with transactions ranging from community banks to GSIBs, this paper endeavors to do two things:

- For bank issuers, we review risk transfer structures in general, including their potential benefits, market development, and reasons why they may be uniquely well-suited for banks in today's market environment.
- For investors, we outline the investment merits of SRT structures relative to other asset-backed transactions and highlight the unique ways SRT deals source bank-originated risk for credit investors.

Synthetic Risk Transfers: U.S. Market Awakens



As of March 2024. Source: PIMCO Capital Markets estimates using data collected from bank annual reports, SEC & FDIC filings, and dialogue with law firms, banks and other market participants. Excludes transactions with multilateral development institutions.

SETTING THE STAGE: DEVELOPMENT OF SYNTHETIC RISK TRANSFER IN BASEL III

First introduced in Europe during the European Financial Crisis, banks began to use risk transfer to leverage the credit quality of their assets as an incremental source of capital. Tier 1 capital is generally composed of the value of banks' equity

and preferred shares, which constitute their capital cushion to absorb losses. However, in times of economic stress, the value of these instruments can fall dramatically, which presents challenges if banks need to raise more capital. While capital may be required, it becomes dilutive to shareholders to issue at valuation levels that are severely depressed.

² Also known as significant risk transfer, credit risk transfer (CRT), and synthetic securitization. All are synonymous.

³ As of March 2024. Source: PIMCO Capital Markets. Non-US equity issuance volume is approximately \$20 billion per annum. At an average tranche size of 8%, this equates to \$250 billion of assets referenced in structures.

Alternatively, investors in risk transfer securities look beyond the stress in equity markets and focus on the fundamental credit quality of bank loan portfolios. The Basel II and III reforms implemented after the global financial crisis developed a framework under which banks could transfer a portion of the credit risk to investors, and insofar as the protection was substantive enough, generate capital relief by reducing the risk-weight of their residual interest in the loans⁴. Instead of carrying the full capital requirement against a portfolio, banks could rely on the protection they've received from investors to fund a portion of that capital requirement. In the event of substantial credit losses, private investors would be liable to incur losses, not equity holders or depositors.

Over the past 15 years, the market has seen the entry of dozens of banking institutions to the SRT market, which has become an established capital tool for global banks, from Europe to Canada, and Japan. This trend was aided by the support of local regulators, who saw the benefit of market participants funding the capital of certain businesses, especially relatively riskier segments like small business, that banks may otherwise prefer not to finance. Further, regulators adopted guidelines and standardized procedures to streamline transaction approval and encourage consistency across banks. Through the establishment of review and submission processes, it became possible to adopt a degree of consistency across institutions, even when the underlying portfolios vary widely, from corporate to consumer loan portfolios.

RISK TRANSFERS IN THE UNITED STATES: WHY NOW?

Despite a flourishing European market and broad regulatory acceptance of SRT, adoption was much slower in the United States. This is not due to any singular fundamental factor, but rather a confluence of generally better capital positions for American banks and a lesser need for institutions to explore alternative sources of capital – until now.

Prior to COVID, a small collection of large banks, including GSIBs, used risk transfers to diversify their capital bases. Following the pandemic, and the unique challenges the COVID crisis introduced to the banking system, a small number of regional banks also entered the market, relying on the credit quality of their assets to help supplement their capital. However, SRT remained a niche product.

That novelty quickly evolved over the past 12 months.

Several key cyclical and secular trends have posed a regime change in banking, forcing banks to quickly re-evaluate their capital plans.

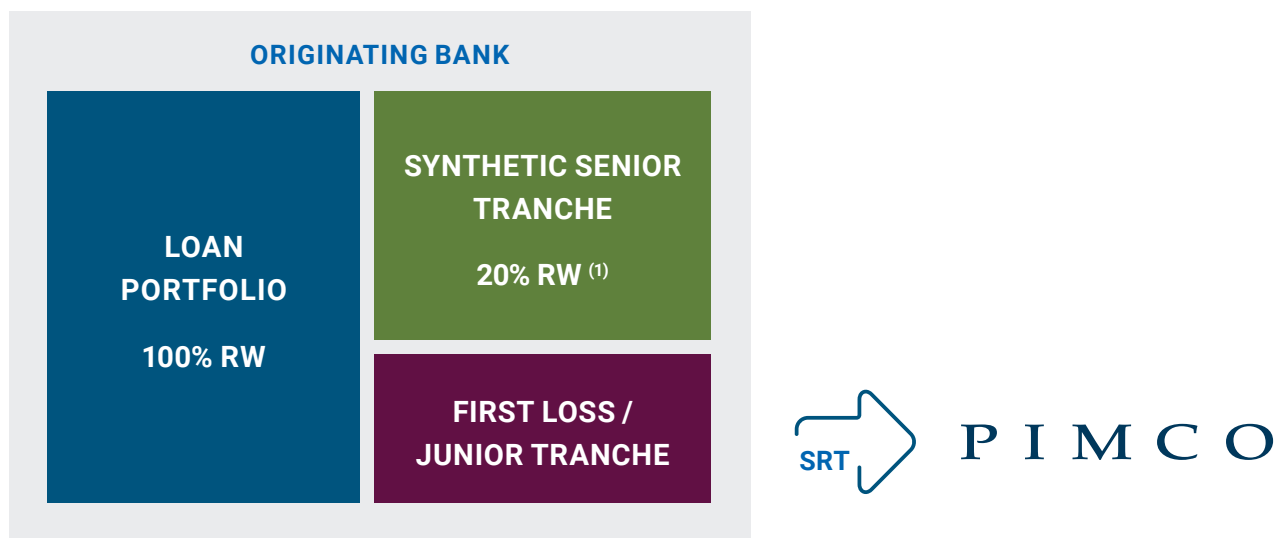
Specifically, Basel III Endgame threatens to increase capital requirements for banks⁵. Liquidity constraints have changed the calculus banks place on their balance sheets, and a high interest-rate environment means that even if a bank wanted to sell a portfolio, many are precluded from doing so because the costs would outweigh the benefits.

SRT is uniquely suited in this challenging environment. While interest rates remain higher, we believe credit remains strong, meaning most assets on bank balance sheets are still performing. This is a key difference from the Great Financial Crisis, where asset quality was much more problematic. Consequently, banks can rely on their strong credit performance to transfer the risk of a portfolio, and since the portfolio is not de-recognized from the balance sheet, there is no mark-to-market loss. By using SRT, banks get the capital benefit as if they had sold the portfolio, but they also get to continue servicing their customers.

⁴ Source: "Basel Regulatory Framework," Board of Governors of the Federal Reserve System <https://www.federalreserve.gov/supervisionreg/basel/basel-default.htm>. As of March 2024.

⁵ Source: Federal Reserve.gov "The Cost of Implementing the Basel III Endgame Framework: Higher Bank Capital Rules Will Hurt Small Businesses and Middle Class Borrowers the Most" by Stephen Moore and David Malpass, February 2024 https://www.federalreserve.gov/SECRS/2024/February/20240209/R-1813/R-1813_011624_156900_343476632430_1.pdf

HOW DOES SRT WORK?



For illustrative purposes only

(1) RW = risk-weight. 12 CFR §217.42 allows for banks to determine the appropriate risk-weight for financings that qualify as securitization exposures, including synthetic securitization exposures. Operational requirements for synthetic securitizations are provided under 12 CFR §217.42(b). Under the Simplified Supervisory Formula Approach (SSFA), the lowest risk-weight that banks can achieve for synthetic senior securitization exposure is 20%, relatively to a baseline of 100% risk-weight for wholesale loan assets.

Synthetic risk transfer, at its most basic level, involves the purchase of credit protection on a portfolio rather than on a single asset. By focusing on a portfolio approach, banks can source liquidity more easily than by selling individual loans.

The typical structure of an SRT transaction involves a bank purchasing credit protection on a portfolio of loans on its balance sheet (the “reference portfolio”). The bank then defines the amount of losses transferred to an investor and the amount retained by the bank.

For example, assuming a \$1 billion portfolio, the bank could purchase \$100 million of first-loss protection, equating to 10% of the total portfolio. This means if the bank experiences losses anywhere across the \$1 billion of referenced loans, those losses are attributed to the investor, up to a maximum of \$100 million. The originating bank only remains exposed to credit risk that exceeds the level of credit protection placed with the investor.

To the extent the portfolio is performing and in good quality, the likelihood that losses exceed the defined risk transfer amount should be low. This gives banks comfort in knowing they have hedged most of the risk. Furthermore, if structured appropriately, this reduction in credit risk may reduce risk-weighted assets, generating capital capacity to increase capital ratios, offset losses, or reinvest into new loans.

Structurally, these deals can be documented in one of three ways:

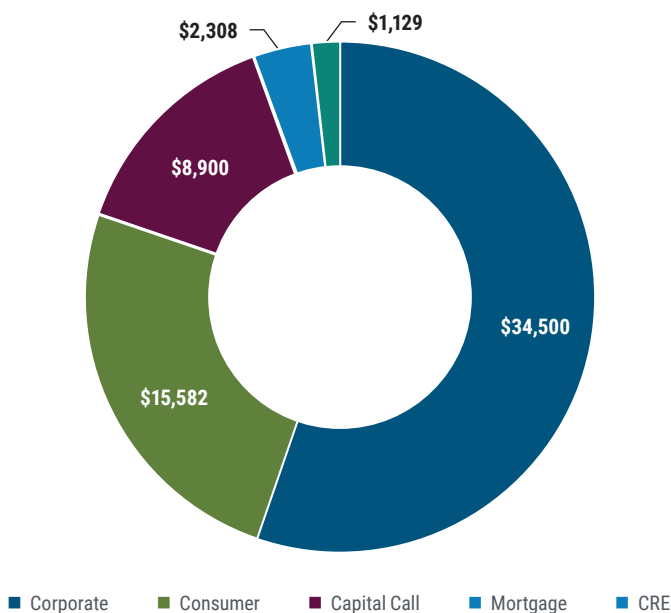
- A credit-linked note issued by a bank
- A credit default swap written by a counterparty
- A credit default swap intermediated by a special purpose vehicle holding collateral

In essence, each of these alternatives is very similar, with nuances based on where cash collateral is held and the type of instrument an investor holds. In contrast to a whole-loan purchases or cash securitizations, there is no excess spread embedded as part of a transaction, and an investor’s return is solely tied to the return on its cash collateral and the fixed premium it earns on the credit protection. In the event of losses, the bank will either write down the value of the liability it has issued, in the event of a credit linked note, or use the cash collateral posted in other structures to cover losses. Under none of these alternatives does the bank take on counterparty risk of the investor defaulting.

U.S. SRT MARKET OUTLOOK AND DEVELOPMENT

SRT issuance in 2023 has emphasized this high credit quality perspective. Many bank assets are positioned to perform well, and strong capital markets reflect that optimism. Additionally, given today's market conditions, SRT on several asset classes would likely generate capital at a level inside the required returns of bank equity capital. Thus, not only is it efficient for banks to raise capital this way, it might also be accretive to shareholders for banks to embrace SRT. In terms of recent U.S. market activity, volume has predominantly circled around investment grade corporates, prime consumer, and subscription finance facilities, all of which are relatively cheap to hedge.

PIMCO 2023 U.S SRT Notional by Asset Class (\$mm)



As of March 2024. Source: PIMCO Capital Markets.

Looking ahead, we expect this trend to continue through 2024 and beyond. Bank assets remain in high demand, and banks will need to buffer their capital bases. Focusing on the highest quality assets will likely be price-efficient for banks and help ensure ample investor demand for high-quality bank risk.

However, we do see ongoing credit challenges around commercial real estate (CRE) assets as a potential second fundamental driver that will force SRT issuance. Because SRT deals genuinely transfer the risk of credit portfolios, banks seeking to reduce their exposure to CRE may embrace SRT to facilitate that de-risking. It may be the case that private investors are better suited to take on the risk of loss of these portfolios, as opposed to depositors. If a bank needs to budget

for increased provisions, its first choice may be to reduce risk-weighted asset charges on higher-quality assets. However, depending on the structure of the balance sheet, focusing SRT on CRE portfolios might be a way for banks to address the narrative of risk-managing their credit exposures.

POSITIONING THE INVESTOR OPPORTUNITY

Synthetic risk transfers provide a potentially attractive diversification opportunity for client portfolios. They offer an efficient medium to access high quality bank-originated credit instruments, which are typically not available in the market due to their unfunded profile or contractual limitations. SRT structures additionally benefit from a potentially attractive and resilient embedded leverage, with the maturity of the referenced pool and no recourse to the other assets of the fund. At the same time, investors in SRT bear the risk of credit losses on the underlying portfolio. If loans default, they are on the hook to cover losses for the bank, and have a capped upside return of the stated spread of the instrument.

With its deep expertise in public and private markets, PIMCO aims to deliver superior risk-adjusted returns in this market through its disciplined and robust underwriting process. This process entails harvesting information from PIMCO's actively managed credit portfolios and a seasoned team of credit analysts, to select bank counterparties, and identify obligors or segments of the referenced pools presenting what PIMCO views as inappropriately elevated default risks.

At the core of PIMCO principles is a commitment to relative value, through the systematic comparison of opportunities across a broad spectrum of financial instruments and related premiums across sectors, regions, durations, concentrations, correlations, among others. While SRT instruments share traits with liquid instruments in the credit derivative and collateralized loan obligation markets, the existence of distinctive SRT characteristics in such as counterparty risk, the issuer's unilateral right to call the transaction early or replenish the reference pools over multiple years, as well as the amortizing profile, offer additional potential opportunities to pick up value.

This extensive underwriting process reflects PIMCO's commitment to seeking to enhance value and optimize outcomes for our clients' portfolios. Anchored on fundamental credit analysis and quantitative analytics, our process leverages PIMCO's best practices across our public market and private market investment processes.

CONCLUSION

SRT has a long history in non-U.S. markets as an effective tool for managing credit risk and marrying the objectives of banks with credit investors in an accretive way. While under-utilized in the United States, that trend line is clearly changing. Our outlook is for increased issuance of SRT in the U.S. market, with broad adoption by banks across the size spectrum, from community banks and regional banks to GSIBs. We believe U.S. banks now have a new tool under their belt for managing credit risk and raising capital, and the market is just now beginning to embrace it.

Past performance is not a guarantee or a reliable indicator of future results.

Forecasts, estimates and certain information contained herein are based upon proprietary research and should not be interpreted as investment advice, as an offer or solicitation, nor as the purchase or sale of any financial instrument. Forecasts and estimates have certain inherent limitations, and unlike an actual performance record, do not reflect actual trading, liquidity constraints, fees, and/or other costs. In addition, references to future results should not be construed as an estimate or promise of results that a client portfolio may achieve.

Statements concerning financial market trends or portfolio strategies are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions or are appropriate for all investors and each investor should evaluate their ability to invest for the long term, especially during periods of downturn in the market. Outlook and strategies are subject to change without notice. No representation is being made that any account, product, or strategy will or is likely to achieve profits, losses, or results similar to those shown.

A word about risk: Investing in **banks and related entities** is a highly complex field subject to extensive regulation, and investments in such entities or other operating companies may give rise to control person liability and other risks. **Bank loans** are often less liquid than other types of debt instruments and general market and financial conditions may affect the prepayment of bank loans, as such the prepayments cannot be predicted with accuracy. There is no assurance that the liquidation of any collateral from a secured bank loan would satisfy the borrower's obligation, or that such collateral could be liquidated. Investments in **residential/commercial mortgage loans and commercial real estate debt** are subject to risks that include prepayment, delinquency, foreclosure, risks of loss, servicing risks and adverse regulatory developments, which risks may be heightened in the case of **non-performing loans**. **Corporate debt securities** are subject to the risk of the issuer's inability to meet principal and interest payments on the obligation and may also be subject to price volatility due to factors such as interest rate sensitivity, market perception of the creditworthiness of the issuer and general market liquidity. **Mortgage and asset-backed securities** are highly complex instruments that may be sensitive to changes in interest rates and subject to early repayment risk and their value may fluctuate in response to the market's perception of issuer creditworthiness; while generally supported by some form of government or private guarantee, there is no assurance that private guarantors will meet their obligations. **Credit-linked notes** are complex financial instruments that are subject to the creditworthiness of the issuer and involve default risk and liquidity risk. **Credit default swap (CDS)** is an over-the-counter (OTC) agreement between two parties to transfer the credit exposure of fixed income securities; CDS is the most widely used credit derivative instrument. **Derivatives** may involve certain costs and risks such as liquidity, interest rate, market, credit, management and the risk that a position could not be closed when most advantageous. Investing in derivatives could lose more than the amount invested. The current regulatory climate is uncertain and rapidly evolving, and future developments could adversely affect a portfolio and/or its investments. In addition, there can be no assurance that PIMCO's strategies with respect to any investment will be capable of implementation or, if implemented, will be successful.

Alternatives involve a high degree of risk and prospective investors are advised that these strategies are appropriate only for persons of adequate financial means who have no need for liquidity with respect to their investment and who can bear the economic risk, including the possible complete loss, of their investment.

PIMCO does not provide legal or tax advice. Please consult your tax and/or legal counsel for specific tax or legal questions and concerns.

PIMCO as a general matter provides services to qualified institutions, financial intermediaries and institutional investors. Individual investors should contact their own financial professional to determine the most appropriate investment options for their financial situation. This material contains the current opinions of the manager and such opinions are subject to change without notice. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission. PIMCO is a trademark of Allianz Asset Management of America LLC in the United States and throughout the world. Pacific Investment Management Company LLC 650 Newport Center Drive, Newport Beach, CA 92660, 800-387-4626.) ©2024, PIMCO

Investment Products

Not FDIC Insured | May Lose Value | Not Bank Guaranteed