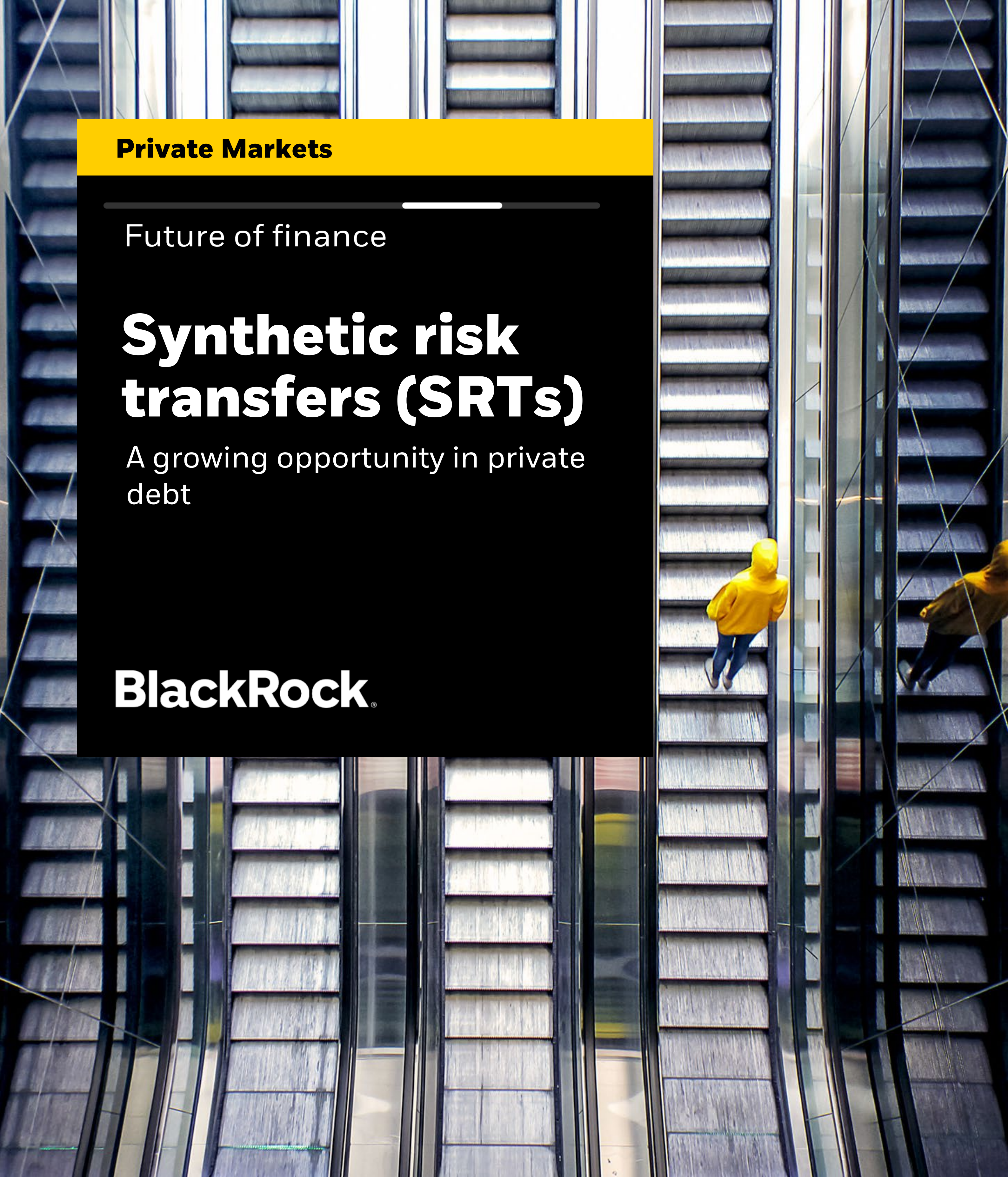
Private Markets

Future of finance

Synthetic risk transfers (SRTs)

A growing opportunity in private debt

BlackRock

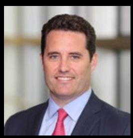


FOR QUALIFIED PURCHASERS, PROFESSIONAL CLIENTS, QUALIFIED INVESTORS, AND INSTITUTIONAL & WHOLESALE INVESTORS

An investment on the rise

March 2024

Authors



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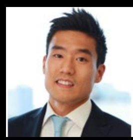

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Key takeaways

- Synthetic Risk Transfers allow banks to effectively sell some of their loan-portfolio risks to investors as a floating-rate note that pays out a steady cashflow.
- We believe SRTs are poised for rapid growth in volume as a result of regulatory changes and increasing comfort among bank issuers and institutional buyers.
- Recent guidance from the Federal Reserve and heightened concerns following the collapse of Silicon Valley Bank may expand the use of SRTs in the U.S.
- Among other benefits, SRTs can offer steady income as well as the possibility of negotiating the characteristics of the underlying assets.

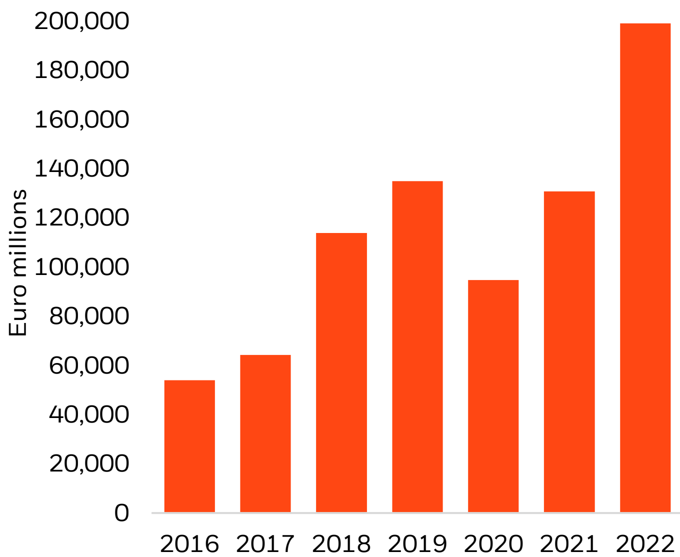
Introduction

Private debt investors often work with issuers who are looking beyond the banks for their funding needs. But there's a small and growing part of the market where the banks themselves are the issuers.

Synthetic risk transfers, or SRTs, have seen double-digit annual growth in transaction volume and total assets in recent years. They have been popular among European banks, with a record number of transactions and originators in 2022, according to the latest figures available.

We believe the SRT market will continue to grow rapidly, boosted by fresh issuances from U.S. banks, which received crucial regulatory guidance late last year. Banks are turning to SRTs in areas of their business that are core and

Getting bigger
The asset pool underlying SRTs at inception, by year



Source: IACPM Synthetic Securitization Market Volume Survey 2023. As of May 31, 2023.

important for client relationships, but that can be inefficient uses of regulatory capital. As a result, the collateral behind SRTs is often of a high quality.

Background

Banks around the world are facing stricter rules regarding capital requirements in certain asset types as regulators take measures to reduce systemic risk in the banking sector.

As a result, banks are required to hold more assets on their books. SRTs are one way banks can do so while mitigating risk and unlocking capital that can be reallocated to other areas of their business.

There are different types of SRTs, but the most popular one is a synthetic risk transfer. In this form of SRT, the bank keeps ownership of the credit exposure while selling a credit protection agreement, or note. Pensions and insurers have been investing in SRTs for a while.

In SRT transactions, a bank specifies an existing pool of assets on its balance sheet and buys protection on the first 5% to 15% of the losses of that pool. If losses materialize, the note buyers take the hit.

Those who buy the notes receive periodic payments from the bank. Note buyers receive a floating-rate coupon, usually offering a fixed premium above the Secured Overnight Financing Rate. This makes SRTs appealing to pension funds and other institutions with regular distribution requirements. Most SRTs mature between 3 and 7 years after issuance.

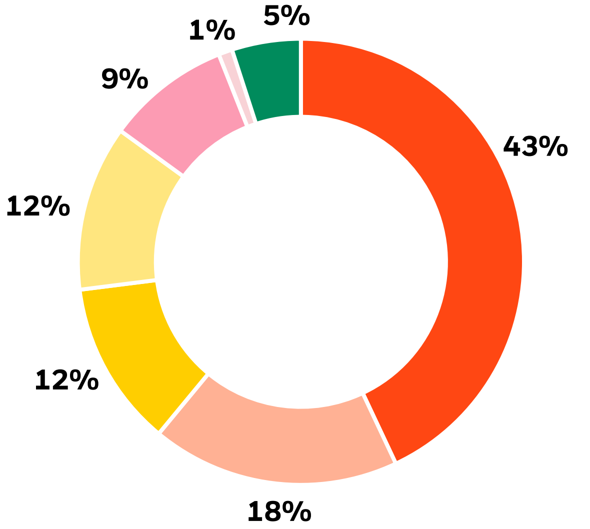
Acronym Check

There are a variety of names for these and similar vehicles, including:

- **SRT** (Synthetic Risk Transfer, Significant Risk Transfer)
- **CRT** (Credit Risk Transfer, Capital Relief Trade)
- **CLN** (Credit Linked Note)
- **RegCap** (Regulatory Capital Relief Trade)

A varied underlying portfolio

SRT issuance by collateral type



Source: EBA Report on STS Framework for Synthetic Securitization, 2021; Structured Credit Investor Database, with information from Pillar 3 reports.

The underlying pools can be made up of a range of debt types, including investment grade, high-yield and revolving facilities, typically rated BBB to B.

The assets that SRTs protect can be loans made to corporates and to small and medium-sized entities, as well as residential mortgages and auto loans, according to the European Central Bank[1].

Rapid growth

In the previous macro regime of lower rates, many banks added more duration to their balance sheets to generate additional yield.

But with today's higher rates, that decision has led to an uptick in unrealized mark-to-market losses. For banks with these assets on their books, SRTs can provide hedging, capital relief, and liquidity without having to sell assets and realize losses.

Source: 1. European Central Bank (Bankingsupervision.Europa.eu), August 2023.

SRTs have been growing rapidly for several years in the EU, due to early adoption by central banks and because banks have found them to be an efficient way to comply with capital guidelines of Basel III and Basel IV.

At the end of 2022, the loan pools underlying SRTs reached close to €200 billion globally, 50% higher than any previous year. While the majority of EU transactions were conducted by just four banks in 2022, numerous other banks have recently entered the SRT market[1].

Banks in the U.S. have been slower to enter the SRT space, but that's changing for two main reasons. Last year's collapse of Silicon Valley Bank and other regionals has increased banks' interest in ways to better manage regulatory capital without selling assets below par. And in September 2023, the Federal Reserve issued guidance around SRTs as they relate to its capital rules[2].

It's important to note nearly all SRTs are cash collateralized up front, which differentiates them from the technology and structures common prior to the Global Financial Crisis.

We believe that the number of banks issuing SRTs will continue to grow, driven by their ability to deliver capital efficiency while lowering the pressure to sell assets at a loss or raise dilutive financing.

The SRT investor base continues to expand to include multi-strategy credit firms and institutional investors outside of Europe.

It should be noted that SRTs are illiquid by nature, with limited activity in the secondary market. And SRTs also have first-loss tranche exposure, meaning that they carry the risk of loss of principal.

The benefits on offer

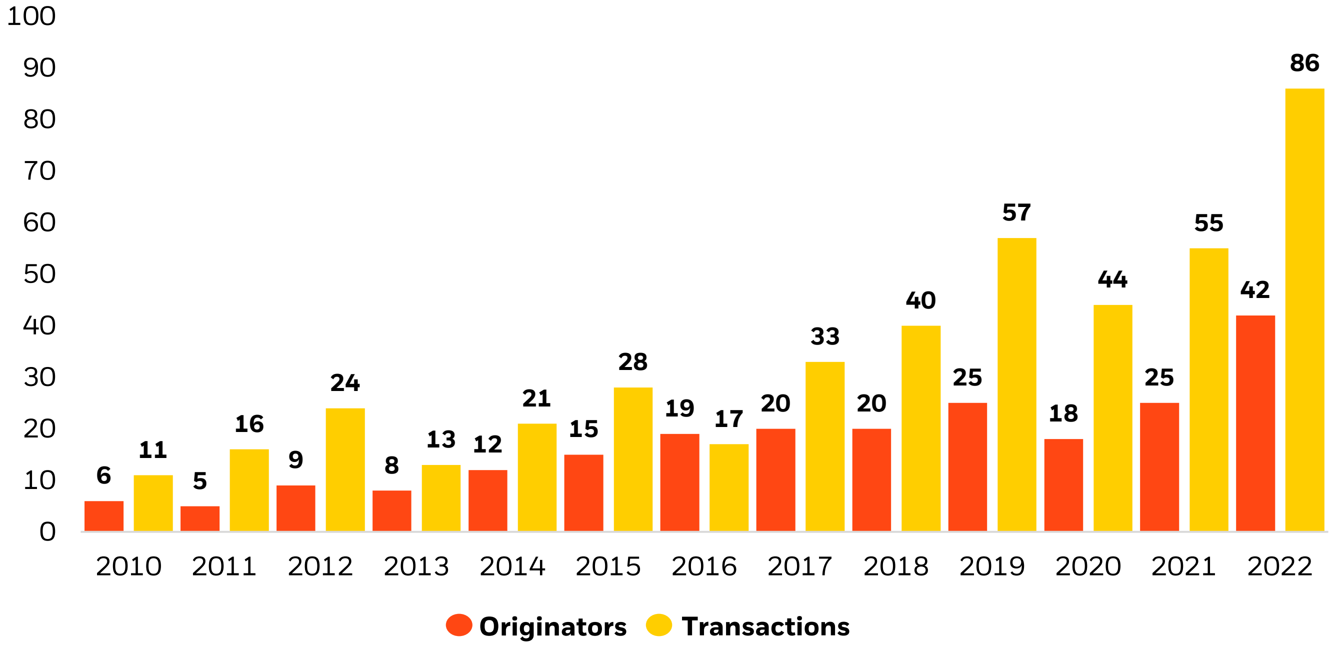
A major advantage of SRTs is that they offer steady cashflows, with periodic payments at a spread over a floating rate.

Another benefit is that large investors could potentially negotiate the characteristics of the underlying asset pools. And the fact that the underlying assets typically remain on bank balance sheets suggests better alignment with banks, in contrast to securitized assets where banks use an "originate to distribute" model.

SRTs can offer diversification, income, and exposure to banks' more tightly-held assets. With the right approach, we believe they can be a compelling opportunity for investors to generate attractive, risk-adjusted returns.

Record numbers

SRT originators and transactions since 2010[3]



Source: 1. ESRB: The European significant risk transfer securitisation market, May 2022; 2. Board of Governors of the Federal Reserve System (Federalreserve.gov), September 2023; 3. Citigroup Synthetic Risk Transfer Transaction Statistics.

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