PEMBERTON

Bank risk-sharing market matures as SRT grows from niche to mainstream

October 2023

Increasingly favoured by banks and endorsed by regulators in all the major jurisdictions, the rapidly expanding significant risk transfer (SRT) market offers institutional investors compelling credit opportunities. Pemberton believes this market will grow three-fold by 2030.

Different people may call it different things: bank risk-sharing, bank capital relief trades, balance sheet CLOs, credit risk transfer, or more commonly significant risk transfer (SRT).

But they all agree on one thing: this is a market that is poised for significant growth over the next few years, driven by increasingly favourable global regulatory and banking industry tailwinds and providing attractive new private market opportunities for investors in the corporate credit space.

So what is risk-sharing? Why is it appealing to bank issuers? What are the attractions for investors? How does SRT compare with other credit instruments – in structure and in performance? How big could the risk-sharing market grow to become over the coming years? And what are the opportunities for investors as the once-niche SRT asset class moves into the credit mainstream?

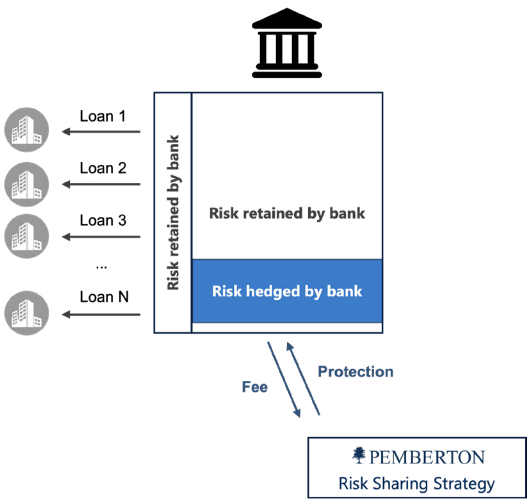

Figure 1: Bank Risk Sharing – High-Level Structure

An increasingly favoured solution to banks' capital needs

SRT is not new. Bank risk-sharing transactions have existed for over 20 years, but the market has witnessed significant growth in the last five years thanks to a greater adoption of the instrument by banks and supportive regulatory developments.

SRT transactions – which are structured as junior tranches (either first-loss or junior mezzanine) of loans originated and serviced by banks – provide banks with ways to keep lending to their core relationships, while delivering attractive and diversifying credit investment opportunities for institutional investors.

Capital and risk pressures have forced banks to reduce considerably their exposure to middle-market leveraged lending and other highly capital-intensive and arguably non-strategic businesses.

For some asset classes, however, banks want to continue lending due to the ancillary revenues they get from activities such as corporate finance, cash management, or foreign exchange. This is especially the case with large corporate lending (typically investment grade or cross-over) and SME financing in the bank's domestic market.

Although banks want to retain their market-leading position in these asset classes, they remain constrained by capital in the light of progressively more onerous requirements prescribed by regulators (notably the current transition to Basel IV).

By hedging a portion of their balance sheet risk through risk-sharing transactions, banks free up capital which enables them to continue lending. Investors in these transactions benefit from access to highly diversified loan portfolios underwritten and held by banks, and to attractive spreads currently in the 10-12% range.

SRT transactions are most frequently driven by the desire of a bank to maintain or improve its capital ratios. A bank facing pressure on its capital ratios typically has three levers: increasing the amount of capital it holds either by raising capital in the market or through retained earnings; decreasing the size of its exposures on balance sheet; or reducing the risk weighting of its assets.

Raising equity capital or reducing dividends tend to be unpopular with shareholders and banks avoid them unless they are forced to do so by regulators. Decreasing balance sheet size by reducing lending or selling loans, on the other hand, can create relationship issues with borrowers and is not conducive to growth.

This leaves the third option – risk weight reduction – as the preferred route for many. This is the motivation for SRT transactions, which allow banks to keep their loans on balance sheet whilst reducing their capital intensity. SRT provides an effective way for banks to engage in risk-sharing transactions with non-bank investors without needing to raise equity or sell assets.

From Niche to Mainstream

As a result, the SRT market is growing rapidly. Pemberton estimates that more than 60 banking groups now have active SRT issuance programmes – mainly in Europe, although the product is also gaining popularity in North America as well – and that over 100 transactions were executed in 2022, with total issuance volume last year in excess of US$20 billion.

Since 2010 the market has shown an 18% annual growth rate of issuance and many new banks are lining up to enter the market. Between now and 2030 Pemberton believes conservatively that at least a further 50 banks will start issuing SRT instruments – with many already working on establishing the necessary programmes and structures to enable them to do so.

In a recent research presentation[1] looking at the growth potential for the SRT market over the next few years, Pemberton set out its base case for a 2.5x to 3x increase in the volume of SRT tranches from the current level of US$54 billion to US$130-150 billion in 2030.

We expect supply to be supported by favourable regulatory developments and the increased cost of capital alternatives for banks in the current market environment. Despite growth in investor demand, Pemberton expects supply pressures to remain strong for the foreseeable future – creating a "buyer's market" that should help to sustain spreads at wide levels and favourable transaction terms for investors.

Although the numbers are large, it is important to note that the base case scenario figures would still only represent around 2.5% of the balance sheet of 110 banking groups globally. In order to achieve the US$130-150 billion volume of tranches by 2030, the supply of SRT tranches would have to increase by 6.5-8.5% annually – well below the historical growth rate of 18% since 2010.

If, on the other hand, the historical 18% growth rate in annual SRT supply were to be maintained over the next few years, the market could grow to total outstanding stock of US$255 billion and annual supply of US$81 billion in 2030.

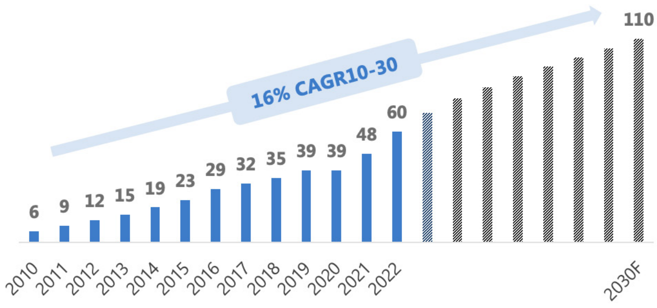

Figure 2: Projected Growth of the Number of Banking Groups with SRT Programme[2]

[2] 2010-2022 data are Pemberton estimates based on data collected from bank annual reports, stock exchanges and dialogue with law firms, issuers and other market participants. Excludes public-sector transactions. 2023-2030 are Pemberton forecast. For illustrative purposes only. There is no guarantee such projections will be realised.

Key supply growth drivers

Factors supporting SRT supply growth comprise a potent mix of favourable regulatory developments, market dynamics and the relative costs of alternative sources of bank capital.

On the regulatory front, the roll-out of Basel IV (which has already been adopted in Canada, and is due to be phased in from January 2025 in Europe) is one powerful driver. Others include more stringent US capital requirements for large banks (which are expected to drive increased SRT supply in the US), clarification of the rules for SRT in Europe and the US, and the adoption of the Simple, Transparent and Standardised (STS) framework in the EU – widely viewed as a game-changer.

In many jurisdictions – most of Europe as well as the US, Canada and also Japan – the largest banks have opened the SRT market. Smaller and more risk-averse institutions are now following their lead and are expected to enter the market in the coming years. That said, setting up an SRT issuance programme requires commitment in terms of both time and money – taking some 12-18 months, and several million dollars, to establish.

But the failures of Credit Suisse, Silicon Valley Bank and First Republic have made investors more wary of bank risk and pushed up the cost of alternative sources of capital for many banks. As a result, SRTs have become relatively cost-efficient – further increasing the attraction to bank issuers.

[1] Horizon 2030: Risk Sharing Market Poised for Significant Growth. Pemberton clients can request the presentation from marketing@pembertonam.com

A Buyer's Market for Years to Come

Supply of and demand for SRT transactions have been relatively balanced historically, as demonstrated by the broadly stable primary spreads that have been observed in the market over the years.

Many investors have entered the market in recent years (including specialist managers, hedge funds, pension funds, and credit insurers), but supply has also grown fast. 2019 was perhaps the recent year that was most favourable to issuers, while since 2022 the growth in supply has outstripped that in demand – partly due to credit funds' capital raising being slower than before.

Market growth in Pemberton's base-case scenario[3] would require investors to allocate some US$230 billion to the asset class by the end of 2030. This is a tall order. Although we believe the asset class is becoming more mainstream and recognised as an attractive proposition from diversification and relative value standpoints, deal sourcing and the ability to underwrite credit portfolios are key hurdles for many investors.

Overall we believe that the market is likely to remain favourable to investors in coming years (with sustained wide spreads, and the ability to negotiate investor-friendly terms with banks) as demand stretches to absorb the surge in supply.

SRTs Shine from Relative Value and Loss Resilience Perspectives

The attractiveness of SRTs for investors stems from a combination of relative value and downside resilience.

Pemberton research[4] compared the performance of SRTs to CLOs, high yield bonds and bank sub-debt (Additional Tier 1, or AT1) since January 2014. We show that the SRT asset class has enjoyed an attractive performance over the past 10 years both in absolute terms (with a 10% annual return) and in comparison to other asset classes – and also with materially higher Sharpe ratios.

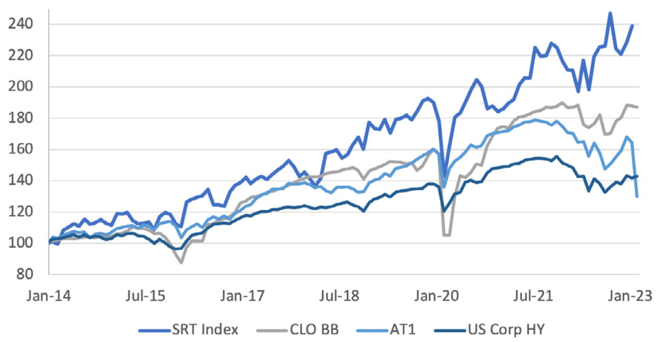

Figure 3: Total Return for Risk Sharing (SRT) vs Comparables[5]

[5]Source: Bloomberg, JP Morgan and Pemberton calculations. Past performance is not a reliable indicator of future results. Extract from Pemberton's Relative Value Perspective report (available on request).

By comparison with the annual return of 10% for SRTs since 2014, the annual returns of the other instruments over the same period have been 3% for AT1s, 7% for BB CLOs and 4% for HY bonds.

The largest driver of the performance of SRTs is the high coupon enjoyed by the asset class. Annual average spreads have oscillated between 9.5% and 11.5% over our sample period and, since 2022, the increase in base rates has also started to benefit SRT returns materially.

The stable and attractive returns that the SRT asset class has delivered over the years have made risk-sharing transactions increasingly popular with long-term investors including pension funds, endowments, sovereign wealth funds and family offices.

Furthermore, our analysis[6] shows that SRTs have displayed high resilience to credit stress. We found that even in scenarios involving multiple times the worst year over the 1981-2021 period, a typical SRT transaction would still have delivered a positive return.

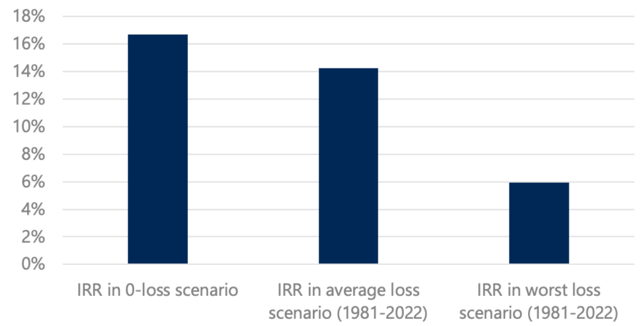

Figure 4: Modelled USD Internal Rate of Returns (IRRs) for Typical Risk Sharing Transaction[7]

[7]There is no guarantee these returns will be achieved. Please refer to Pemberton's Resilience of Risk Sharing Report for the methodology.

We attribute this return stability to the Basel regulatory framework which requires banks seeking capital relief to hedge a tranche of risk exceeding even the most conservative loss scenario. This results in investments with very diluted risk but relatively high coupons that can withstand severe periods of credit stress.

A Market Set for Growth and Attractive Returns

Looking ahead, Pemberton believes that a strong case can be made for sustained high returns in SRTs, though a combination of supply pressures keeping spreads wide and favourable structural terms mitigating downside risk.

We expect greater adoption of the products by banks and investors alike and this once-niche market to establish itself as one of the key structured credit asset classes in the near future.

[3]Horizon 2030: Risk Sharing Market Poised for Significant Growth. Pemberton clients can request the presentation from marketing@pembertonam.com
[4]Risk Sharing Transactions: A Relative Value Perspective. Pemberton clients can request the report from marketing@pembertonam.com
[6]The Resilience of Risk Sharing Transactions to Stressed Credit Environment. Pemberton clients can request the report from marketing@pembertonam.com

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