Growth expectations

Alastair Pickett, co-portfolio manager of Chenavari's risk sharing strategy, answers SCI's questions

Q: As the team prepares to launch a new fund around its risk sharing strategy within the next few months, can you give us some background to SRT at Chenavari?
A: Our risk sharing business sits alongside and is complementary to our private credit investment strategy, through which we cover both portfolio acquisitions and warehouse financing extended to our non-bank lending partners. We are very active in consumer, mortgage and SME asset classes with our non-bank lenders, and this broad experience lends itself to how we view risk sharing across granular portfolios.

Focusing on the risk sharing market itself, we have been actively involved since 2011, and I believe that we are one of only a handful that can claim to have been a foundation investor in this market in its current form.

Q: And how does that influence your approach?
A: To illustrate this question with an example, we assisted one of the largest currently active bank issuers to establish their credit risk sharing programme in its current format, executing a bilateral transaction with them after working closely with them on multiple parts of the approval and structuring process. Our perspective and experience lends itself to working very closely with issuers like this, given the complexities a bank faces in setting up a programme, obtaining regulatory and internal approvals, and the systems that they need to establish for portfolio selection and replenishment.

Q: What does 'risk-sharing' mean to you?
A: What we're primarily focused on is alignment of interest with the bank. We call these transactions risk sharing for the precise reason that we're aligned and sitting side-by-side with the bank.

We have seen various terminology being used for these types of transactions, including capital relief transactions, significant risk transfer, regulatory capital transactions. But for us, it's about building long-term relationships with, and being a reliable partner for, the bank.

Taking a broader view, risk sharing has become a very important tool since the GFC, to effectively help share risk around the financial system rather than having it concentrated on banks' balance sheets. Therefore, we feel that the growth of risk sharing is a beneficial development for the entire financial system.

Q: How significant are barriers to entry in this market?
A: Barriers to entry are still quite high in terms of the volume of work that investors need to do. These are very complex transactions and investors need to be aware of that.
I think there's a great deal of work required by investors on the underwriting process of these transactions. When we underwrite a transaction, what we're really underwriting is the bank's underwriting of the credits. Therefore, it is key to understand these processes in detail, and how you can compare across issuers.

We are also talking about banks which, in this context, are disclosing sensitive proprietary information and therefore have to carefully manage which investors have access to that.

Q: How do you source deals in this market?
A: We source deals in a variety of ways, the main route being direct conversations with the bank's portfolio management team, discussing where they see their pinch points from a capital perspective. That is really a two-way conversation: we want to see how we can help the banks to execute transactions in the asset classes where they feel they have the most pressure and help them shape their upcoming transaction needs.

Another trend to mention in the sourcing strategy is the increased presence and significance of advisors in this market. I think they've played a key role in furthering the development of the market in recent years and helping to connect banks and investors.

Q: How would you describe your relationship with issuers in the SRT space?
A: As alluded to in the previous question, it is fundamental to a successful long-term investment strategy to have a very good relationship with issuers. We certainly value a close and long-lasting relationship, so that we can get to understand how we can work together in a mutually beneficial way.

Issuers really value counterparties who are reliable execution partners. As a team, we can provide banks with early feedback on their transactions and make sure that we communicate clearly our preferences and red lines.

Furthermore, we closely follow the regulatory environment and intimately understand the parameters around the structuring of these transactions, which helps to have productive conversations around transactions with banks.

Q: Is the SRT market in your view still relatively under-invested?
A: I think we are going through quite a rapid transition right now from a niche market into a more mainstream market. Over the last 12 months or so, we have seen a tectonic shift with the broad restart of the US market and also Canadian issuers coming to the fore. Yet I wouldn't necessarily say that the market has been underinvested to date.

We believe it will take some time for supply and demand to rebalance through the course of 2024. However, we think that there will be sufficient supply being generated both from new and existing issuers over the coming years, making risk sharing an attractive asset class to invest in for the foreseeable future.

Q: Do you have specific preferences regarding asset classes or jurisdictions?
A: Chenavari's DNA is rooted in European credit, which remains our core focus, but we do invest in global large corporate portfolios as well, and these make up a significant part of our invested book. However, with granular portfolios, we generally restrict to European jurisdictions, both core and periphery, although we haven't been involved yet in the growth witnessed recently in Eastern European jurisdictions.

Looking at asset classes, we invest across both large corporate and granular asset classes, including SME, consumer credit and trade finance. We feel we can really add differential value from what we see in the private credit space across these asset classes. We tend to avoid lumpy and/or long-dated portfolios, and therefore we tend not to be competitive on the more CRE or infrastructure focused deals.

Q: Do you typically prefer blind or disclosed pools and why?
A: We invest across both blind and disclosed pools, which is not so surprising, given our broad asset class coverage. Just over half of our current portfolio mix is made up of blind granular pools.

What is important to us when looking at a non-disclosed pool is that the pool is sufficiently granular and avoids concentrations, so that we can complete an adequate statistical analysis. Through that process, we're essentially simulating the potential outcomes of a transaction, given careful analysis of through-the-cycle historical data and applying macro stressors to that analysis.

In the large corporate space, portfolios are typically less granular. Therefore, we're able to look through and undertake a specific name analysis. Naturally, it is a very different type of analysis and a very different type of investment.

One thing we pay close attention to with disclosed pools is whether we are building up excess concentration to a single name within our overall fund. There are a number of underlying syndicated loan names that can appear across multiple transactions and we need to be very careful that we maintain diversification across our fund exposures.

Q: What does your underwriting approach involve?
A: As mentioned previously, we are really focusing on the bank's underwriting methodologies. We've seen a lot over the past decade, and so can effectively benchmark the quality of the bank's underwriting.

There can be quite a bit of variation in the approach of banks to underwriting and, in particular, the monitoring of their portfolios. For example, in the SME space, we will look at the bank's underlying relationship with those SME borrowers: how much overall business does the SME do with the bank? Has that relationship been long-lasting enough for the bank to form an adequately robust credit opinion on the SME and finally, does the bank utilise the data it has to the fullest extent?

Another thing that we pay close attention to are the bank's internal ratings. We are trying to make an overall assessment of the quality and stability of those ratings, analysing how they evolve through time. This allows us to form predictors of credit events in a transaction. We are also looking at what the bank does on a downgrade; for instance, what approach the bank might take to avoid that credit ultimately transitioning into a default state.

Q: Regarding the market this year, what specific trends have you identified?
A: We've obviously seen the rise of transactions from the US, triggered by the larger banks with significant volumes, particularly in the large corporate space. Going into 2024, we expect slightly more interesting portfolios to come out of those banks. We should also start to see development of the market in the US, as has happened across Europe, where smaller first-time issuers and more regional banks are coming to the fore.

Thinking about transactions in Europe, we are seeing banks take steps to address counterparty risk. Counterparty risk has been an important topic for us since last year's mini-banking crisis and, as an investor, we're really looking at sharing risk with the bank on their underlying portfolio, rather than taking on that bank's counterparty risk.

Counterparty risk in the cash securitisation market is quite comprehensively considered and, as the synthetic market evolves, it should be addressed further there as well, particularly across non-systemically important issuing entities. By that I mean being more strict on collateral segregation and potentially setting up backup bank account arrangements for the collateral account on day one.

Finally, regulation will continue to drive issuance. Regulation continues to ramp up, both in terms of complexity and in terms of capital requirements for banks.

Although banks across Europe are currently well capitalised with respect to Basel 3 rules, banks' ambitious growth plans will quickly induce incremental pressures on capital. We expect regulatory

pressures and developments to be an increasingly relevant theme over the next three to five years, at least.

Q: Do you plan to increase your allocation to the sector going forward?
A: In short, yes. To date, we have viewed risk sharing as very much a part of a broader and more diversified private credit strategy. While we still intend to offer our LPs that broad opportunity set, we think the opportunity in risk sharing is now attractive enough to consider launching a single strategy product.

We feel that in terms of risk/reward in this product, this is an ideal time to enter the market. It's an exciting time to enter the market too because we believe there are going to be real step-changes in terms of growth.

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This article was published in Structured Credit Investor on 12 March 2024.