Risk transfer and the shift from camaraderie to competition

The risk transfer market could be moving into a more competitive, more transactional and, some fear, riskier cycle

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NEED TO KNOW

- Bank risk-sharing trades are drawing in new investors, including big asset managers, private equity firms and non-specialist credit hedge funds.
- Deals that before were negotiated by a handful of participants now might, at times, include broad syndicates.
- Long-standing players in the space worry that a spirit of trust will give way to a sharper, more transactional, culture.

- New entrants can be more aggressive in the counterparty risks they will take on, incumbents say.
- Some think that resolving operational problems could become harder in a less collegiate environment.

The days of a clubby market for synthetic risk transfer (SRT) may be over, as the competition for banks' business intensifies.

The SRT market, in which banks transfer some of the risk of their loan book to buy-siders, often for yields as high as 16%, is experiencing an influx of new, and new types of investors. And these buyers of bank risk no longer wait around for calls from bank issuers – nowadays, they make the calls themselves.

The buzz at an annual gathering of risk transfer specialists in London this March was that banks are now fielding enquiries from new potential counterparties weekly, as the number of bidders coming to the SRT table grows apace. But plenty of old hands in the space worry about what this could mean for the market and for them.

"Conventional wisdom goes that we're going to make all of these improvements, and everything is going to be better," the head of credit risk sharing at a large hedge fund tells *Risk.net*. He and others, though, are uncertain about what they're giving up.

The sector is changing from a cottage industry to an industrialised version of the business, he says. "But maybe there's some value in managing this in a smoke-filled back room, with a sort of craft mentality that gives us [as investors] added flexibility that is actually healthy."

The sector has **grown steadily in Europe** and is burgeoning in the US, where **regulatory changes** made last year have reopened the market.

In 2023, banks offloaded risk from more than $300 billion in underlying loans in deals worth $25 billion. The figure is up from $20

billion in 2022 and $15 billion the year before, according to industry estimates.

With more issuance on offer, new investors are flooding the space, including asset managers like BlackRock and Pimco, private equity firms like Blackstone and Ares Management, and non-specialised credit investors more familiar with trading instruments like asset-backed securities (ABS) and collateralised loan obligations (CLOs).

"I was talking to an arranger yesterday, and he told me he signed an NDA [non-disclosure agreement] on one trade with close to 100 investors and he went to the second round with more than 20," said Harry Noutsos, managing director at Prime Collateralised Securities, a non-profit that verifies the quality of securitisation deals for regulatory purposes, speaking at the event, which was hosted by IMN (Information Management Network).

For now, deals with dozens of participants remain the exception, say investors. Most transactions continue to be done with a handful of investors, or bilaterally. But the future direction of the market could skew that way.

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Head of credit risk sharing, large hedge fund

Some bank issuers are actively courting the new buyers – who are often willing to bid more aggressively and offer better terms for the issuer.

Others in the industry have voiced their misgivings to *Risk.net*. Several longstanding SRT investors warn that new entrants to the space could drag lending standards in the asset class lower – particularly if those firms choose to ignore bank counterparty credit risk. A less clubby approach to dealmaking could also lead to

difficulties or even disputes, investors fear, especially when dealing with the operational risks that often arise in this area.

Risk expertise transfer

Investors in risk transfer deals provide banks with protection on part of their loan portfolios. Banks issue high-coupon notes to investors and hold the proceeds as cash on deposit, or with a third party or in the form of high-quality securities as collateral, depending on the structure negotiated. Investors must pay the bank if a credit event, such as bankruptcy, occurs with respect to the underlying loans.

For the banks, the cost of passing risk along in such a way is lower than the regulatory capital charge they would otherwise incur.

The market is private, so evidence about trends in investor behaviour is anecdotal. But established market players point to new entrants from among private credit and CLO funds as being particular agents of change.

These investors look to transfer expertise from the markets in which underlying loans are originated, says Alastair Pickett, portfolio manager at hedge fund Chenavari Investment Managers. "We're seeing that across private credit funds who have the expertise to look at granular pools of retail or SME [small and medium enterprise] loans, as well as hearing it anecdotally across funds focused on shipping or CRE [commercial real estate] loans," he says.

CLO specialist funds are entering the market, too, Pickett reports. "These funds are used to analysing corporate portfolios bottom-up, as well as understanding securitisation structures, so are well placed to participate when they see good relative value across corporate risk-sharing tranches versus mezzanine or equity CLO pieces."

The immediate effects have been unsurprising. "If you have 20 investors competing for one deal, think of the impact," said Noutsos at the London event, recalling the story of an initial syndicate of a hundred.

Kaelyn Abrell, co-portfolio manager and partner at ArrowMark Partners, told delegates at the conference of "some pretty aggressive spread compression over the last year", that he described as "universal across the market". Though each transaction is quite unique, she clarifies.

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> **Harry Noutsos, Prime Collateralised Securities**

And established players worry this kind of aggressive bidding will only intensify. In particular, newer market players often seem to be willing to take on more bank credit counterparty risk, the older hands say.

Depending on the size and profile of the bank, SRT deals are often priced to include investor protections for the risk of a bank counterparty failing or suffering losses in other parts of its portfolio that might affect its ability to repay principal.

"We are aware that some of our competitors are potentially less sensitive to pricing in counterparty risk," Pickett says. "As a result, we're not seeing a significant pricing differential across transaction structures. I think the difference has become quite marginal."

Alan Shaffran, senior portfolio manager at Magnetar Capital, says he has been priced out of deals in the past when bank credit spreads were trading at more than 200 basis points over risk-free rates. "We were told it was because we were pricing in credit protection when other counterparties weren't."

And he believes more of this sort of behaviour is likely. "There already has been some aggressive behaviour, and there's no doubt in my mind there will continue to be some aggressive behaviour as the market further develops," he says.

Some investors also see, in how deals are structured, the signs of how competitive new entrants are willing to be. "We're still seeing smaller regional banks issuing direct CLNs [credit-linked notes]," says Pickett.

"Albeit with rating triggers." This surprises him, he says, after last year's US regional banking crisis. Direct CLNs can allow banks to hold the notional investment from investors uncollateralised as cash on deposit.

Rating triggers, which would force a bank to move SRT notional to a third party, for example, can take months to execute, say investors.

Trust fall?

Looking forward, established market players also voice concerns about the potential for operational difficulties.

The underlying loans in SRT transactions stay on a bank's balance sheet, meaning investors rely on the lender's internal processes for the lifecycle of the transaction. This means managing the underlying loan, replenishment – when maturing loans are rolled over – data collection, and so on.

The administration can be complex. For revolving loans, for example, if maturity dates are not properly updated, a replenishment could be construed as a restructuring. Credit teams in banks are large and staff turnover can at times lead to loan details being lost. **Vast amounts** of loan data needs to be given to investors and can be delayed or incomplete.

"It's easy to say you're covered for failure-to-pay, bankruptcy or restructuring, but what does that actually mean?" says Robert Bradbury, head of structured credit execution at Alvarez and Marsal, referring to the disparity of interpretation that can arise, not least when data communication is incomplete or inaccurate.

There's a natural asymmetry of information in these transactions, which makes a strong relationship of paramount importance

Alastair Pickett, Chenavari Investment Managers

Before now, such questions have been worked out between issuers and investors one-on-one or in small groups. "As an investor, we take the view that, yes, there may be some friction, there may be some post-deal noise, and we may have to reopen documents in order to address issues that impact the efficiency of the transaction for the bank," says Kaikobad Kakalia, chief investment officer at Chorus Capital. "Obviously that works better in a bilateral [deal] or a small club, but not in a syndicated trade."

Chenevari's Pickett, likewise, stresses the role of trust in such dealings: "There's a natural asymmetry of information in these transactions, which makes a strong relationship of paramount importance".

"When we invest in a risk-sharing transaction, we form a close partnership with that bank. As part of that, we need to be confident the bank is going to originate and manage its book diligently and in line with strict processes."
By the same token, a breach of good faith by an investor might lead to being excluded from future deals. Magnetar's Shaffran says: "We've completed dozens of deals over the past 15-plus years and part of the necessary condition to being considered a good counterparty in these transactions is to be a strong partner over the life of a deal."

To be clear, isolated instances of adversarial behaviour have occurred. But they are rare, practitioners report. Most of the time, investors have agreed to pay, regardless of operational hiccups along the way. "It's much more common for people to work together and come to an agreement as to how such situations are resolved," says Bradbury.

What's bothering SRT specialists, then, is the chance that this culture of trust might be undone.

The rise of opportunistic players increases the risk an investor could bring a case against a bank, they say, especially with the influx of US investors, who tend to be more litigious.

The field's "relationship-based model" is giving way to "transactionality", worries the hedge fund credit risk sharing head. It could make the market more cyclical, he reckons, and more "brittle".

"We saw a deal from a large EU bank that was super widely syndicated, clearly transactional, not relationship-based," the executive says, questioning what happens when such practices become more widespread. "What happens when the mindset begins to shift?"

Diff'rent strokes

None of this is to say the market participants *Risk.net* spoke dismiss out of hand the value of having more players in the space, even if these new players take risks the incumbents wouldn't.

"This is simply the way the market works. If people want to take counterparty risk, for example to get perceived relative value, they can do that," says Bradbury.

At times, new investors might also be very welcome. "Investors that have term locked-up capital take a buy-and-hold view and therefore tend to negotiate differently as they emphasise risk management at the front end," says Kakalia. "In difficult markets, they're the capital provider of choice," he says, citing the Covid pandemic as such a period.

Several market participants acknowledge there is more room in the market for investors with different risk-return objectives.

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Robert Bradbury, Alvarez & Marsal

"Every transaction is different," Kakalia told the London conference. "A number of the tighter transactions are also transactions that have a very low average risk profile… To some extent we are seeing a market that is bifurcated between transactions that are pretty straightforward, very high quality – with externally rated borrowers – and easily accessible to a number of investors.

"Then there are others which are more difficult and have risks that are more complicated to underwrite, and here pricing hasn't tightened meaningfully."

The expectation, however, seems to be that some of the new entrants will not stick around.

"We need the market to grow to support the banks that are going to issue at a higher rate," Abrell told delegates at the March event. "I think some investors will stay, and others will be transient based on the opportunity set." Either unattractive prices or unexpected losses could cause some to exit the space, she said.

Established players will hope the new investors that remain in SRT will adopt some of the habits of the old.

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