The Investment Podcast

Episode 31: The Investment Podcast: An Introduction to Significant Risk Transfer
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Romil Patel: Hello, and welcome to *The Investment Podcast*. My name is Romil Patel. I'm delighted to be joined here today by James King, Head of Structured Credit to M&G Investments. Welcome to the podcast, James. You've been investing in the structured credit market for a long time.

James King: Hi, and thanks for having me. I've been, indeed, investing in structured credit for over 20 years. Currently, my team looks after about 6 billion in AUM covering AAA down to non-investment grade, and in particular, I think what we're going to talk about today is a significant risk transfer, which is one of the most interesting areas of structured credit that we see at the moment.

Romil: Indeed, well, the focus for today's discussion is on bank capital relief trades, which are also known as significant risk transfer or SRT transactions. An SRT transaction is first or second loss protection purchased by a bank on a diversified pool of core lending assets. For example, loans to large corporations, as well as SMEs. The origins of the SRT market date back to the 1990s. However, the market as recognised today, has only existed since the introduction of Basel II in late 2007.

Over the years, this type of transaction has become more common, but why do they exist and what are they precisely?

James: Really, the reason they exist is one of the big trends that we're seeing across financial markets, which is banks in general need more capital for every unit of lending that they do and that's pretty much across the board. This is obviously a continuation of the regulations that were brought in after the global financial crisis. You mentioned Basel 2, but since then we've effectively had Basel 3 and Basel 4. We've also had IFRS 9. These regulations have generally made a whole variety of bank lending quite inefficient from a return-on-capital perspective.

At the same time, particularly in Europe, I think there's been a general recognition post the GFC that banks were too big. As a percentage of a nation's GDP, some of these banks' balance sheets were well over 100%. There was a real fear that some institutions were too big to fail so, again, a general desire to see banks' balance sheets shrink. That's why SRT exists. It's one of a number of tools by which banks can reduce the capital required to put against their lending activities.

The general idea is, give you an example. You mentioned SME loans. We could take a portfolio of let's say a billion of SME loans, effectively, the way the regulator looks at that billion of SME loans, they would say around the first 100 million of cash associated with those loans is effectively at risk, i.e. that's the amount of capital that you might need to put against that billion of loans. If an investor comes along and says that, "I will effectively protect you, the bank, for the first 100 million of losses on that portfolio," then in turn, the bank can significantly reduce the amount of capital it needs to put against those loans. That's what SRT is. In general, it's a means of identifying a particular part of a bank's balance sheet and then you, the end investor effectively providing the capital the bank needs to perform that lending.

It's particularly popular for asset classes that the banks consider core to their activities. Loans to SMEs would be a good example. Revolving credit facilities to large corporates would be another, but that don't lend themselves additionally to being sold. One of the ways in which banks are shrinking is they're also selling a lot of portfolios, but that tends to be non-core portfolios or portfolios where the bank doesn't need to maintain a relationship with the borrowers.

Things like loans to SMEs, things like revolving credit facilities, the bank still needs that relationship with the borrower. Really, SRT is a really good way of actually improving the bank's capital position but at the same time allowing the bank to retain that relationship.

Romil: Thanks, James. As mentioned just a short while ago, the SRT market, as we know it today, has only been around since 2007. Over the years, how have you seen it evolve and what direction do you see it going in?

James: There's been a number of changes to the market. I think initially post the GFC, there wasn't a great deal of standardisation in these transactions. Certain national regulators were not keen on these transactions and so, effectively, we saw many countries, [where] the transaction didn't exist. Then the documentation itself in terms of what constitutes risk transfer also varied from deal to deal. That made it quite difficult from an investor perspective to try and figure out how far you can push a transaction in terms of obviously, it's our job to minimise the risk for our investors, and it's the bank's job to try and move as much of that risk as possible off their balance sheets onto the investors who are effectively being paid to take that risk.

One of the key things that I'd say really galvanised this market was around the middle of the last decade when the ECB issued a number of guidelines and rules for what they wanted to see within a significant risk transfer transaction to actually allow that capital relief for the banks. It was very prescriptive in terms of some of the structural features they would allow, some of the things that they'd seen, that they didn't like. This, I think, made it very much easier for issuers and investors. In terms of issuers, knowing that if they put a transaction together that was in line with the ECB's guidelines, their national regulator would approve it and would allow them the capital relief.

Similarly, the investors knew how far they could push, what was going to be acceptable to regulators and what wouldn't. It was really from the middle of the last decade that we saw much more standardisation and that led to a lot more jurisdictions and frankly a very big increase in issuance, both in terms of the number of banks bringing these deals to market and also the types of assets being brought. To put it into context, I'd say 2013/14, so only 10 years ago, we might have seen maybe 12 transactions a year. If we go forward to today, 10 years later, I think we're looking at 12 transactions right now. Deals that are going to be closing either in August or September. I think total year, for this year, we'll probably see around 80-plus transactions. We've gone from 7 or 8 banks and 3 or 4 jurisdictions to 20-plus jurisdictions and 70-plus banks being considered as SRT issuers. I'd say the market has really grown quite substantially, but also changed I'd say in a good way, in terms of that standardisation and investors being clear on what's acceptable and what isn't from a transaction perspective.

I think one of the key things obviously worth bearing in mind as well, that I guess since the market really developed in Europe, as I say around 10 years ago, we also saw banks from other jurisdictions outside Europe also look to do significant risk transfer transactions. We've seen deals from banks in Asia, including Japan. We've seen deals in Canada, a significant number of deals in the US, and I hear of deals potentially being done in South America, Southern Africa, and also Australia and New Zealand.

It really has become a kind of global sort of market, albeit it's still dominated by European banks for the reasons I mentioned earlier, namely the banks themselves are very large. Also, they're the ones that have had the weakest return on capital, generally speaking over the last 10/15 years. Therefore the ones that are looking the most to become more efficient with that capital usage.

Romil: James, you've been successfully operating in the structured credit space for more than two decades. When you sit back and survey the landscape, what attributes does a patient investor need to show in order to successfully invest in SRTs?

James: I think the main attribute for success for us is only investing in transactions where you have a very good comfort level with the financial institution that is sponsoring the transaction. Also, making sure that you have good institutional knowledge about the underlying assets. It's stating the obvious, but to give you an example, we've seen SRT transactions on shipping assets, for example. Now, at M&G, shipping is one of the few areas where we don't have an expertise, so that's just something that we're not going to look at. Similarly, there are plenty of banks that come to market that we feel are not particularly strong in that type of asset origination, in that particular jurisdiction that they're looking to do an SRT transaction on. How do we know that? Well, we've got our very large banks team who help us figure out which banks we want to do deals with, and once we've decided which banks we want to do deals with, which assets do we think those banks are good at. I think they're the key areas, just don't stretch the envelope in terms of what you're looking at.

That's really been, I think, one of the benefits of this market growing as fast as it has. It's allowed us to grow our exposure to this asset class without ever moving beyond that very simple only working with sponsors that we like and only working with assets that we feel that we fully understand.

Another key area that I think it's very important to bear in mind is the fact that these transactions are essentially private transactions. That means there is no public sources of information to help you make your credit assessment, or certainly limited. That means you're having to do the vast majority of the research yourself, which includes financial modelling. Each one of these transactions has to be modelled individually, so it's very important to have a team of people who are exceptionally good at that side of things and the accuracy that's required for modelling these transactions.

At the same time, thinking about how you stress these transactions when you run them through your model, what is an appropriate stress for a particular transaction in a particular jurisdiction? Again, that really comes down to having good institutional knowledge about how different asset classes behave in different jurisdictions in a stressed economic environment. Again, having that weight of institutional research that we have behind us, I think, has really helped us to pick the transactions which are likely to perform the best in more difficult economic environments.

Romil: Given where we are in the cycle, why are SRTs interesting to investors at this point? With all the various pockets of volatility, what makes this more appealing than cash?

James: I think the first thing to point out, though, is of course, if we take the UK for it, as an example, while cash rates are optically, very generous, 5 or 6%, whatever it might be right now, that's still some way short of inflation. If you're going to sit in cash, you are still effectively losing money. What we're talking about with SRT is typically transactions that have paid, in sterling terms, coupons of 10 to very high teens percentage returns, so you would have been getting, certainly, significantly compensated for taking the risk.

The other thing to point out, of course, is that, as I mentioned earlier, these transactions are private. There is a secondary market for them, but it's pretty limited. To get exposure to SRT transactions is not straightforward. It's not like moving into equities or corporate bonds, or indeed cash. You, essentially, have to build a portfolio, and it takes time.

The other thing, I think, that's worth pointing out is, right now, with the difficult economic environment that we're in, with the kind of, I think, fairly risk-off tone that we've seen in credit markets in general for the last 18 months, these transactions are actually very attractive right now versus what we've seen historically. If I look at a typical SRT transaction and compare it to one that I might have seen maybe in 2021 or, let's say, the last time we had a bit of a bull market, 2019, I will see a transaction that gives me a better spread. It will be a better-quality transaction in terms of underlying collateral, and I may well have a thicker tranche, which means I've got a less volatile return profile.

Those things don't exist in perpetuity. They exist because, right now, the market is saying, "There is uncertainty, and we want to be compensated for these additional potential risks."

We think this is a really good time to invest because essentially, you are seeing transactions that are factoring in the uncertainty, and say, just bearing in mind that if risk appetites return, in general, to markets in 6 to 12 months' time, it will not be easy to build a portfolio of SRT risk. A lot of the transactions that are being done now, they go to buy-and-hold investors. They will be bought. Those investors could enjoy the returns from those assets for the next 5 to 7, 8 years and they just won't be on the market in 6 to 12 months' time. We do think it's a very interesting time to be putting money to work in this area.

It's also worth mentioning that one of the things that we've observed about SRT is that in periods of market volatility, actually performs pretty well from a price perspective. Even though I mentioned that there is not a particularly deep secondary market, there is a secondary market of sorts, we do see SRT trade from time to time. What we observed during, for example, the early months of Covid-19, or during the volatility that we saw in the European markets at the end of last year, that SRT actually held up very, very well from a price perspective.

Certainly, the drawdown that we saw in SRT was far lower than we saw in other non-investment grade asset classes, particularly within structured credit. There are a couple of good reasons for that. One is SRT investors tend to be buy and hold, so you don't get the same panic selling as you might see in other markets or where people are dashing for cash. The other reason is we feel that structurally they are quite stable. Clearly, they are junior investments so there's obviously a high element of risk, but actually, when you analyse an SRT transaction and break it into its component parts, we think you're essentially buying a very thick equity tranche. You could split that equity tranche up further into equity B, BB, and even BBB. Again it's that stability of returns that reflects that risk profile that also I think means that we feel it's quite an interesting asset class to be involved in even if you are concerned about the economic environment.

Romil: Thanks, James. Well, unfortunately, that's all we have time for on today's episode of *The Investment Podcast*. James, it's been a real pleasure to look beyond traditional assets and get granular on SRTs with you. Thanks indeed, again for sharing your insights.

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James: Thank you very much.

Romil: Thanks to you, our audience, as ever for tuning in. We look forward to seeing you on the next episode of *The Investment podcast*, but it's goodbye for now.

Speaker 2: For further information, please view the notes which accompany this episode. This podcast is for investment professionals only. The value of investments will fluctuate, which will cause prices to fall as well as rise, and investors may not get back the original amount they invested. Past performance is not a guide to future performance. The information and views expressed should not be taken as a recommendation, advice, or forecast.

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