SRT DEALS

Passing the parcel

Banks are shifting slices of loan risk to pension funds through significant risk transfer deals, offering schemes fresh diversification and returns, but also drawing regulatory scrutiny. Giovanni Legorano **reports**

A once-obscure corner of bank finance, significant risk transfer (SRT) deals are fast becoming the latest hunting ground for pension funds eager for yield and diversification.

In essence, a typical SRT deal sees a bank hedge a pool of loans against default by selling credit-linked notes to pension funds and other investors, such as sovereign wealth or hedge funds.

Such deals allow banks to free up capital they would otherwise need to meet regulatory requirements. This capital can then be used to back the issuance of more loans.

These transactions have long been used by European banks, but they have become prominent among global investors more recently after US banks entered the market.

Investors

Pension funds are no longer just dipping a toe into the SRT pool, they now account for a meaningful slice of the market, according to the European Banking Authority.

Its *Spring Assessment Report* issued in July, found that pension funds account for 13 per cent of the SRT market but could have indirect exposures to the asset class via other investments.

Private credit funds are the main investors in SRTs, with around a third of the market, followed by other investment funds, insurance companies and the schemes, showing the interlinkages in the financial sector, Europe's top banking regulator said.

Dutch investment manager PGGM, which manages €248.5 billion in assets for Dutch pension fund PFZW, has become a prominent player in the risk transfer space, with €6.7 billion invested in credit risk sharing by the end of 2024 – exposure that corresponds to some €80 billion worth of loans.

It made a 9.9 per cent return over these assets last year and an average annual return of around 12 per cent since 2006.

For PGGM Investments senior director, credit risk sharing, Angelique Pieterse, SRTs are an important tool to diversify credit risk for pension funds and get solid returns, while making a contribution to society.

"We see it as a win-win," says Pieterse. "We can access credit risk, which we wouldn't be able to find otherwise in the market. And it is a very helpful instrument for banks to be competitive, support them with capital tailored for specific lending activities, while ensuring that all the loan exposure that banks keep on their books, on their own account, is sufficiently capitalised."

She adds: "This also allows us to contribute specifically to lending that supports the carbon transition of the economy, like loans to renewable energy projects and loans with specific transition-related KPIs."

Pieterse says that PGGM, which has made 86 such deals with 18 leading banks over the past 19 years, has been applying a number of ground rules.

For example, it always requires the bank originating the loans and engaging in a credit risk sharing transaction with them to retain at least 20 per cent of the risk associated with loans included in the deal.

In addition, PGGM only invests in funded SRTs and is very conscious of the counterparty risk related to the funding.

"The funding should not be on an unsecured cash deposit with the bank [*originating the loans*], because if it faces an overnight issue, your money falls within the bank's bailout plan. We wouldn't be exposed to a diverse group of borrowers anymore, but to a large bank," she says.

Pieterse and her team spend considerable time in the due diligence phase to understand both the underlying exposures as well as the approach of the banks with whom PGGM partners to the specific lending business.

"We speak to everybody in the channel that originates. To the senior management team, to the bankers who have client contacts, to the risk management team, to the workout team, to the sustainability team and to the know-your-customer team," she says.

"You really need to know what you risk share. If you don't understand the market, don't start risk sharing it, because you can't do a good, proper due diligence. You don't know the right questions to ask," she adds.

This is why PGGM engaged in transactions involving several different types of loans, such as loans to large corporates and small and medium enterprise, trade and project finance, but wouldn't, for instance, risk share loans to the shipping sector.

Regulatory warning

As the market gathers pace, Europe's banking watchdog has sounded a note of caution, warning that risk transfer can sometimes mean risk concentration.

"It remains important that this risk is also properly managed by banks going forward, not least amid their rising SRT usage: If these newly issued SRTs have similar maturities, it can quickly happen that a maturity wall is built up in the future," the EBA said in its July report.

However, it added that data for the wider banking sector didn't point to the existence of such a "maturity wall".

The regulator also warned about the potential "circles of risks" being created by banks providing funds to investors that are taking on credit risk from other lenders.

M&G Investments head of structured finance, James King, says they are both legitimate concerns from a regulator's point of view.

"It's important to stress that capital is linked to a defined portfolio of reference obligations, not reference entities," he says. "I think it all comes down to balancing. It's never going to be 100 per cent of the banks' capital [*involved in these transactions*], so it's a regulatory question of what the right percentage is. I think it varies from bank to bank and jurisdiction to jurisdiction."

King adds that SRTs can be quite "thick" and, therefore, leverage can potentially be introduced safely from an investor's perspective, but it is an understandable regulatory concern.

"We are very nervous about leverage anyway. We think the way to do it is to work with a third-party investor who can pick the tranche that you don't want, because probably it's an investment grade and, for a high-yield manager, that would dilute your returns," he says.

A spicy alternative

For investors, the appeal lies in flavour – SRTs offer a spicier premium than the plain-vanilla high yield options on the menu.

For example, King sees SRTs as an attractive investment if they offer a premium compared to the returns coming from more vanilla forms of high yield credit.

"We think that SRT has consistently delivered that, even though we have seen some spread tightening in the past two years. Most SRT transactions still provide that premium, although there are clearly deals that we think don't offer the kind of premium to take on the risk," he says.

Veritas portfolio manager, Ville Iso-Mustajärvi, says his pension fund has a meaningful allocation to SRTs.

"It allows you to get significant premia compared to the plain vanilla, liquid forms of instruments," he says.

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He adds that the market has evolved into many different sub-asset classes depending on the underlying loans.

"There are a lot of relationship driven aspects to this market and there is a lot of modelling involved to make an informed decision," Iso-Mustajärvi continues.

"Since we are a relatively small pension fund, with around €5 billion of assets under management, we decided to use external managers to get exposed to this asset class," he says.

In recent years, Iso-Mustajärvi has seen a lot of new players entering the market, which translated into increased volatility in the pricing of these transactions. However, he says he still has a cautiously positive outlook on the asset class.

Such investments are popular primarily in European countries where pension funds have substantial amounts of assets under management and a more sophisticated investment approach, says Aon Italy partner and head of wealth, Claudio Pinna.

For instance, in Italy, they haven't gained a lot of traction so far, he says. In particular, he says that for defined contribution pension funds, Italian savers tend to be very risk-averse, and this type of investments would be included in the riskier plans, which tend to be shunned by the majority of members.

However, he says that it remains an interesting asset for pension funds and is used by larger schemes around Europe, which have a longer track-record of looking into less plain vanilla investment options and an even stronger need for diversification than smaller schemes. "It is clearly in line with the investment strategy of this type of investors," he says.

As Europe's pension funds keep searching for diversification and yield, SRTs may be moving from niche to mainstream – albeit under the watchful eye of regulators wary of the risks that come with the rewards.