Risk-sharing remit

Most practitioners agree that ‘risk-sharing transactions’ is the most appropriate moniker for capital relief trades, but there remains some divergence around the term. **Corinne Smith** explores what it means for investors and issuers alike.

The term ‘risk-sharing transactions’ is becoming more common and more widely understood to denote capital relief trades, but divergences remain around what different investors require as part of a risk-sharing agreement. However, what is clear is that to create a sustainable CRT market, such transactions must function appropriately for all stakeholders.

“It’s important to have a universal label for the strategy because it is helpful in generating interest in the product and encouraging allocation among investors. Unfortunately, there is no industry association solely representing managers of CRT strategies; such an organisation could standardise the label and advocate for regulators to accept it,” suggests one CRT investor.

The ‘balance sheet synthetic securitisation’ label – which appears to be the term preferred by regulators – is technically correct: it describes the mechanism of transferring risk from banks to investors. Meanwhile, ‘risk transfer’ has connotations of trying to dispose of all the risk.

In contrast, while ‘risk-sharing’ doesn’t technically describe what the product is, the term conveys the spirit of what CRT issuers and investors are seeking to achieve. “It’s a subtle difference in terms of the ability to create a meaningful narrative for prospective clients. Ultimately, we’re seeking access to performing, core assets where banks need help from a return on equity perspective – and synthetic securitisation is the most efficient method of achieving this. We’re not set ▶

Richard Robb, Christofferson, Robb & Co

Genuine sharing of risk entails a genuine sharing of loss: if there is a loss, it is experienced in the same way by both PGGM and the partner bank. But while the standard securitisation risk retention is 5%, PGGM requires partner banks to retain 20% of the risk.

"We are a dedicated investor of pension money, seeking to establish long-term partnerships, so it makes sense to have this alignment. The idea is that we're in it together and jointly feel the pain," explains van Drooge.

since it may make them a bit more competitive when sourcing deals. "Some hedge funds are opportunistic in terms of asset class – seeking the best return across the securitisation market, whether it's CRTs, CLOs or ABS. But several hedge funds have raised money specifically for CRTs and are similarly looking to create partnerships with banks and want to remain invested in deals when they roll over," he observes.

The investor concurs that risk-sharing should be based on a proper partnership, whereby the

up to invest in the transmission mechanism, but the underlying portfolio," the investor observes.

Richard Robb, ceo of Christofferson, Robb & Co, says that a true risk-sharing transaction transfers risk from a bank to an end-investor, satisfying both the letter and the spirit of significant risk transfer. In contrast, 'regulatory capital arbitrage' is not sustainable: the risk-sharing transaction should not change the behaviour of the issuer towards the loans the transaction protects.

"As far as I'm concerned, it shouldn't matter whether a risk-sharing transaction opens lines for new lending or de-risks the bank. The bank can decide how to run its business," he observes.

He continues: "True sharing means buying into the bank's credit policies, the bank's workout practices with its customers and, indirectly, the bank's ESG standards. An investor shares the losses that the bank really experiences; in other words, there is no artificial determination of loss by fixed LGD or other mechanisms. It is naïve to imagine that an RST investor re-engineers the bank in any meaningful way."

Barend van Drooge, director, credit and insurance-linked investments at PGGM, says that his firm cares about genuinely sharing the risk of the core activities of partner banks in the areas where they are market leaders. Partner banks will have been doing business in these areas for decades and the expectation is that they will continue to do so, providing comfort that the bank has in-depth knowledge and those activities are well looked-after.

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PGGM also requires partner banks to collateralise the investment notional in order to mitigate counterparty risk. "This stipulation provides certainty that both the bank and investor can get their money when needed. In addition, this ensures that the transaction doesn't eat into counterparty credit limits that all pension funds have to banks, so that these can be used elsewhere in the business," he observes.

One CRT structurer agrees that requiring a minimum 20% risk retention makes sense. "Anything below that level and you're not really risk-sharing," he suggests. "I personally think the 5% risk retention specified in the securitisation regulation, for example, is too low. The same credit risk exposure should be shared pari passu between issuer and investor to ensure proper alignment – whether it's a synthetic or true sale securitisation."

The structurer also indicates that some hedge funds may accept 5% risk retention, especially

bank has skin in the game and there is strong alignment of interest among parties. "The objective is for us to do well when the bank does well and vice versa. Transactions reference portfolios comprising a bank's best clients, who are well supported by the bank. As such, the bank is not laying off the exposure, but rather freeing up capital to lend more."

He notes that risk retention forms part of the alignment of interest, but it is not the only aspect to consider. Other factors evidencing alignment of interest include understanding the motivations behind the bank doing the trade and whether the issuance forms part of a programme.

"It's in the interests of banks for their CRT programmes to perform well, to ensure there is a market for the next deal from the programme and to create a track record," the investor observes.

An additional consideration is whether the bank's operations are set up properly. For example,

is there a Chinese wall between the team selecting the assets and the risk management team?

The CRT structurer notes that term to maturity is also important in terms of risk-sharing. "Typically, investors aren't fully aligned in the sense that deal maturity is sometimes shorter than loan maturity. However, banks accept that this is market practise."

There are several advantages to creating long-term partnerships between CRT issuers and investors. One is being there when a deal matures, so it can be rolled over and the investment maintained.

"We start negotiating prior to maturity about new deals with most banks. As a result, the bank benefits from certainty of having a source of capital available and it means we have stability of investment," notes van Drooge.

Another advantage of long-term partnerships is that the arrangement can be expanded into other jurisdictions or lending activities of a bank. Furthermore, having real-life experience of how the bank performs and operates provides valuable insights and ensures follow-up deals can be executed more swiftly and be even better finetuned to each party's requirements.

Barend van Drooge, PGGM

Van Drooge points out that for some, synthetic securitisation still has a negative connotation – due to how arbitrage synthetic securitisation was applied in products which eventually led to the global financial crisis. Over recent years, however, the benefits of balance sheet synthetic securitisation – as it is applied in bank loan credit risk-sharing – is increasingly being recognised.

But he notes: "The situation remains fragile and if there is a blow-up because a deal isn't well structured and those risks materialise, the stigma will re-emerge. A risk-sharing transaction must make sense across the board – for investors, issuers and regulators."

"A RISK-SHARING TRANSACTION MUST MAKE SENSE ACROSS THE BOARD – FOR INVESTORS, ISSUERS AND REGULATORS"

Meanwhile, Robb notes that there are three things a true risk-sharing transaction is not. The first of these is a vehicle for recycling systemic risk back into the financial system.

"Investors should not be other banks. Similarly, in the public sector, sharing the risk of a systemically important bank with a government-sponsored agency seems to me to miss the point," he remarks.

The second thing a true risk-sharing transaction should not be is tricky. "Investors and issuers should both accept the potential for losing money," Robb explains. "Tricky and 'simple, transparent and standardised' are overlapping concepts but not the same. It is possible, say with a mixed pool of assets, to construct a complex non-standardised transaction that efficiently transfers credit risk."

The third is that true risk-sharing transactions should not be tied to any risk besides credit. "Unlike, say European SMEs, operational risk is not an asset class to which institutional investors seek exposure. It resides naturally with the bank," Robb states.

Van Drooge suggests that scrutiny of the market can be addressed by industry participants explaining what they're doing and how they're mitigating risk as transparently as possible. "Otherwise, something else could come along that is less manageable," he warns.

Overall, van Drooge believes that there is positive momentum for the risk-sharing market. "The adoption of the STS synthetics framework demonstrates that policymakers recognise the utility of capital relief trades and that they can be standardised. Equally, the coronavirus crisis has underlined that credit risk-sharing works, in that banks knew they could call on their partners when necessary."

There are three main stakeholders in the risk-sharing market: regulators, banks and investors. "These stakeholders need to be aligned in order for the risk-sharing market to grow in a rapid and sustainable way," the investor states.

He concludes: "Regulators understand the value of the technology and are trying to put the correct rules around it. New banks, in turn, are entering the market because they're increasingly comfortable, given the robust regulatory recognition of SRT. The current ethos works well with most participants." ■

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