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Opportunities in Synthetic Risk Transfers (SRTs)

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The US banking industry is undergoing significant changes that are creating new markets for fixed income investors. One of those markets is Synthetic Risk Transfers or SRTs

US regional banks, particularly larger ones, are facing mounting pressure due to higher capital requirements and persistent funding costs, challenging their profitability and prompting new strategies.

Non-bank lenders are increasingly entering core lending markets traditionally dominated by banks. Instead of competing directly, banks are collaborating with these non-banks to expand client relationships and access new markets.

SRTs were created to allow banks to transfer asset risks to investors, improving capital management and reducing loan exposure. These transfers also help banks partner with non-banks, creating opportunities to work together instead of competing.

The US SRT market is expected to expand rapidly in the coming years, potentially catching up with the more mature European market. This growth presents opportunities for investors as SRTs offer steady cash flows and high yields, backed by high-quality bank loans.

The Investment Case for SRTs

SRTs present non-bank investors, such as asset managers, insurers and credit funds with a unique opportunity to gain access to high-quality, bank-originated assets that offer attractive yields. One of the key benefits for investors is the alignment of interests—banks retain a vested stake in the performance of the underlying loan portfolios, promoting prudent management. For investors looking to diversify their fixed income portfolios while seeking enhanced returns, SRTs provide a compelling blend of yield, risk management, and exposure to private credit markets. Below are the main reasons why we believe SRTs can be a valuable addition to an investor's portfolio.

- **ATTRACTIVE YIELDS**
  Recent SRT transactions have offered yields ranging from SOFR plus 8% to 12%, which is significantly higher than most traditional fixed income assets.
- **DIVERSIFICATION**
  SRTs provide exposure to private credit markets, offering less correlation with traditional fixed-income assets like government or corporate bonds.
- **CUSTOMIZABLE RISK-REWARD PROFILE**
  Investors can choose specific risk tranches (e.g., mezzanine or first-loss) depending on their risk appetite, allowing for a tailored investment strategy.
- **ALIGNMENT OF INTERESTS**
  Both banks and investors share in the risk, so that banks retain an interest in managing the portfolio prudently, thus mitigating potential downsides.
- **REGULATORY-DRIVEN MARKET EXPANSION**
  With increasing regulatory clarity in the US and continued growth in Europe, the US SRT market is expected to expand, presenting timely opportunities for investors.
- **CAPITAL EFFICIENCY FOR BANKS**
  SRTs enable banks to manage their capital requirements more effectively, which supports the growth and stability of these transactions, giving investors' confidence in their ongoing viability.

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A Closer Look at SRTs

A Synthetic Risk Transfer (SRT) is a financial tool that allows banks to manage credit risk by transferring a portion of their loan portfolio's risk to third-party investors, such as asset managers, insurers or credit funds. In these transactions, banks retain ownership of the loans but reduce their exposure to credit losses. Common terms used in SRTs include:

- **CREDIT LINKED NOTES (CLNS)**—A debt instrument issued by banks to transfer the credit risk of a specific loan portfolio.
- **VERTICAL SLICE**—A risk-sharing arrangement where the bank transfers a proportional share of the risk to investors.

These terms will be referenced throughout this paper to illustrate SRT mechanics.

SRTs are designed to help banks reduce exposure to unexpected loan losses while maintaining the loans on their balance sheets. This makes SRTs a critical risk management tool for banks aiming to protect capital and sustain long-term financial stability.

The mechanics of SRTs vary depending on the type of collateral, contract duration and risk-sharing structure, but all SRTs serve the same core purpose: mitigating risk. By transferring some of the credit risk to external investors, banks can manage potential losses more effectively, promoting the health of their balance sheets without removing assets. In return, investors receive regular payments for absorbing these risks, with returns linked to the performance of the underlying loan portfolios.

Types of SRTs

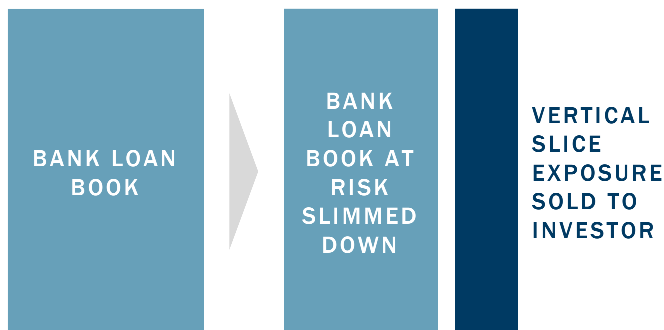
There are two primary structures of SRTs, each offering a distinct approach to risk sharing (Figure 1):

- **NON-PAYMENT INSURANCE (NPI)**—This type of SRT involves a "vertical slice" risk-sharing arrangement, where the bank transfers a portion of the risk from a specific loan portfolio to investors on a proportional (pro-rata) basis. The bank and the investors share the risk and reward in the portfolio. Banks often use NPIs to reduce exposure to risk within certain portfolios—such as commercial real estate or auto loans—while freeing up capital for new lending opportunities.
- **FUNDED SRTS**—In this structure, the bank retains the safer, senior tranche of the loan portfolio and transfers the riskier, subordinate layers to investors. Funded SRTs typically involve issuing **Credit Linked Notes (CLNs)** through a **Special Purpose Vehicle (SPV)** or directly from the bank. Investors are compensated for taking on these riskier layers, while the bank gains capital relief and reduces its risk exposure for the duration of the transaction. This structure focuses on transferring specific risk layers rather than sharing risk across the entire portfolio.

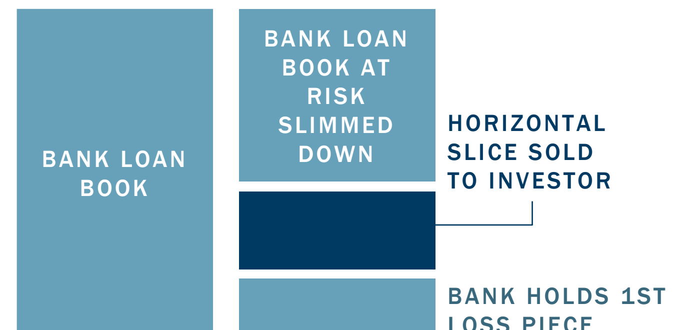
As shown in Figure 1, which illustrates the core function of SRTs, banks retain ownership of the loans while transferring portion of the risk to investors. This alignment of interests between banks and investors is a key benefit of SRTs, differentiating them from traditional securitization methods like Asset-Backed Securities (ABS) or Mortgage-Backed Securities (MBS), where the bank transfers most or all of the

FIGURE 1: CORE FUNCTION OF SRTS

NON-PAYMENT INSURANCE



FUNDED SRT



Source: MacKay Shields

risk. SRTs create a shared-risk framework, allowing banks to manage their capital more efficiently while offering investors an opportunity for attractive returns.

Banks Issue SRTs for Risk and Return Purposes

This section outlines the reasons banks are increasingly issuing SRTs and the key advantages they gain from these transactions. By entering into loan book risk-sharing agreements with investors, banks can effectively manage their balance sheet risks, improve capital efficiency and free up capacity for further lending. These benefits explain why the SRT market continues to grow (Figure 2) and why banks are likely to further expand their use of this tool in the future.

- **IMPROVED RISK MANAGEMENT**
  The main goal of SRTs is to help banks better manage unexpected risks in their loan portfolios. SRTs allow banks to transfer specific risks—such as those related to sectors, clients, or geographic regions—to third-party investors. This reduces the bank's overall credit risk. However, the bank must also manage the risk associated with the investors taking on those assets.

- **BETTER CAPITAL MANAGEMENT**
  Banks must follow regulations that require them to hold capital to cover unexpected loan losses, with the amount depending on the loan type. For example, for a $100 auto or corporate loan with a 100% risk weighting, a bank must hold $10 in capital if it maintains a 10% common equity tier 1 ratio. An SRT can transfer some of this risk to investors, which reduces the risk weighting of the loan (e.g., from 100% to 20%). This frees up capital and improves the bank's equity ratio. If the SRT costs less than the bank's cost of equity, it can also improve the bank's return on equity.

- **OPTIMIZATION OF LOAN PORTFOLIOS AND MANAGING LENDING LIMITS**
  SRTs enable banks to optimize their loan portfolios by reducing exposure to specific sectors or clients. This allows them to lend more to current clients, expand into new industries or serve new clients they previously avoided due to risk concerns. Essentially, SRTs give banks more flexibility in managing and growing their loan books.

Managing an SRT program involves several costs that cannot be ignored. Banks need to invest in robust loan reporting systems and pay fees to structure these transactions. More importantly, banks pay investors for taking on the transferred risk, which means a portion of the interest income from the loans goes toward protection fees. As the use of SRTs increases, banks may see a reduction in net interest income due to these payments to investors.

Burgeoning US Market

The US SRT market has significant growth potential, with estimates suggesting it could reach at least $1.5 trillion in the coming years (Table 1). SRTs are particularly useful for low-risk but high-risk-weighted assets like auto and commercial loans. With $12 trillion in total loans, including $1.8 trillion in consumer loans and $500 billion in auto loans, the market could expand significantly, freeing up capital for banks and improving risk management.

According to Citi Research, the US SRT market currently stands at approximately $75 billion in consumer and mortgage assets, with $7 billion issued in Credit Linked Notes (CLNs). The market is expected to grow rapidly as US banks increasingly turn to SRTs to optimize capital and manage regulatory risk. Industry trends and regulatory adaptations point toward strong expansion in the near future.[1]

US Market Poised for Growth as it Catches Up with Europe

The regulatory capital market for synthetic securitizations has experienced substantial growth from 2016 to 2023,

TABLE 1: US SRT Market Has Significant Growth Potential

	Size	Addressable SRT Market
TOTAL LOANS	$12TR	$1.5TR
TOTAL CONSUMER LOANS	$1.8TR	$230BN
AUTO LOANS	$0.5TR	$60BN

Data as of September 2024.
Addressable SRT Market refers to the expected size this market can grow to based on current loans outstanding and future SRT issues structured comparably to previous issuance.
Source: FDIC.

1. Source: Citi Research

highlighting a steady increase in both the number of trades and the size of the underlying asset pools (Figure 2). Over this period, the number of synthetic securitizations grew from 29 trades in 2016 to 90 trades in 2023, with the underlying pool size expanding from €54 billion in 2016 to €199 billion in 2023. The total protected tranche volume followed a similar upward trajectory, increasing from €5 billion in 2016 to €197 billion in 2023.[2] This growth is reflective of the broader expansion of synthetic securitization as a risk management tool, with banks across different regions adopting these instruments to manage regulatory capital and enhance their lending capacity. The growth in issuance, particularly in 2022, surpassed pre-pandemic levels, indicative of the increasing demand for such structures, driven by more global participation and evolving market dynamics.

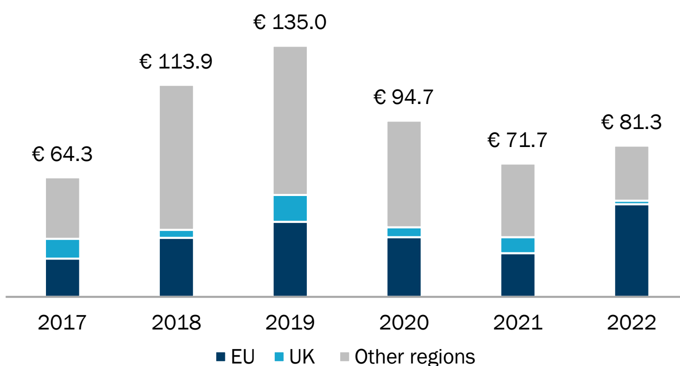
The US SRT market has historically lagged that of Europe (Figures 2 & 3), where regulatory clarity and early adoption post-2008 Global Financial Crisis allowed the European SRT market to grow rapidly. European banks capitalized on this structure to improve capital efficiency, especially in high-risk loan portfolios. In 2023, European banks issued approximately $189 billion in SRTs, far surpassing the $15 billion issued by US banks.[3]

In contrast, US banks have been slower to embrace SRTs, partly due to less regulatory clarity. However, recent developments indicate that the US market is set to expand significantly. The Federal Reserve recently provided more explicit guidelines on SRT transactions, including the use of Special Purpose Vehicles (SPVs) and Credit Linked Notes (CLNs), allowing banks to transfer risk without requiring prior approval for each transaction, and a few have begun to take advantage (Table 2). This regulatory shift is expected to accelerate the adoption of SRTs by US banks, especially as they face rising capital requirements.

As larger US regional banks—those with assets between $100 billion and $250 billion—come under increasing pressure to improve capital efficiency, SRTs offer an effective tool for managing risk and maintaining profitability. In particular, US banks are likely to follow in the footsteps of their European counterparts, using SRTs to reduce exposure to commercial real estate and other high-risk loan portfolios. Given the size of the US banking industry and the demand for capital relief,

FIGURE 2: REGULATORY CAPITAL MARKET GROWTH

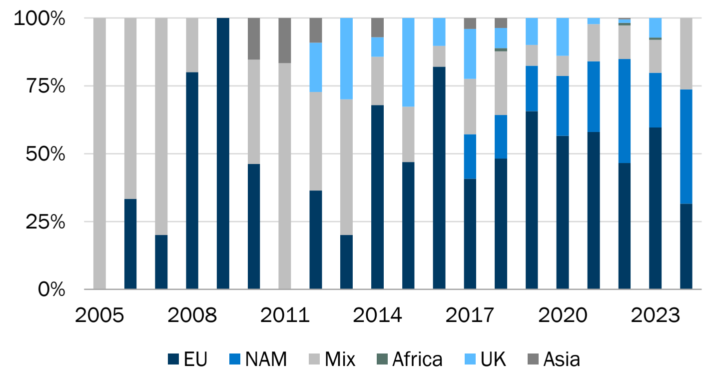
UNDERLYING POOL SIZE AT INCEPTION | €BN



Source: International Association of Credit Portfolio Managers (IACPM)

FIGURE 3: EUROPE HAS TENDED TO BE THE MAIN SOURCE OF ISSUANCE HISTORICALLY

DEAL COUNT DISTRIBUTION BY COUNTRY



Source: International Association of Credit Portfolio Managers (IACPM)

2. Source: International Association of Credit Portfolio Managers (IACPM)
3. Source: International Association of Credit Portfolio Managers (IACPM)

TABLE 2: SRT Deals in 2024

Bank	Collateral Type	Type	Deal Size $BN
ALLY	Auto Loans	CLN	2
CITI	IG Corporate Loans	SPV	5
HUNTINGTON	Auto Loans	CLN	4

Source: Citi Research, J.P. Morgan, BofA Research and MacKay Shields

industry analysts project that the US SRT market could grow to between $1.5 trillion and $3 trillion over the next few years.[5]

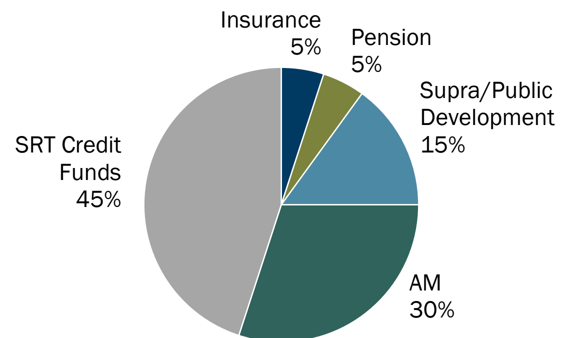
With greater regulatory clarity and growing pressure on banks to manage capital efficiently, the US SRT market is poised to catch up to Europe's more mature market. As US banks increasingly adopt SRTs, investors will have more opportunities to participate in these transactions, potentially benefitting from high-quality, bank-originated assets and attractive yields.

Looking forward, we see several factors as motivating banks to issue SRTs.

- **IMPROVED RISK MANAGEMENT |** After the funding and capital pressures of March 2023, regional banks are more focused on reducing risk, particularly in commercial real estate. SRTs can help them manage asset concentration risks more effectively.
- **SHIFTING RISK-REWARD PROFILES |** The risk-reward dynamics of certain loan categories, like residential mortgages and loans in climate-sensitive areas, can fluctuate due to regulatory changes. For example, the Federal Reserve may increase capital requirements for mortgages or loans in high climate-risk zones. This shift would make these assets more capital-intensive for banks, prompting them to use SRTs to manage these risks efficiently. By offloading some of the risk to investors, banks can reduce the capital burden tied to these changing risk factors while maintaining loan origination.
- **GROWING INVESTOR INTEREST |** The higher yields in SRTs, compared to other fixed-income products, are attracting asset managers and credit funds, which are expected to boost the US market as investor interest increases (Figure 4).
- **RISING CAPITAL REQUIREMENTS |** Larger regional banks (with assets between $100 billion and $250 billion) face higher capital demands, making SRTs an appealing tool for optimizing capital, managing profitability and enhancing shareholder returns in a high-cost environment.
- **SHIFTING ROLE OF REGIONAL BANKS |** The role of regional banks is changing as non-bank financial institutions, such as asset managers and private credit firms, increasingly provide capital to small and medium-sized businesses. To adapt, regional banks are partnering with non-banks to originate and distribute loans, seeking to grow fee income without increasing capital needs. SRTs offer an alternative tool for managing risk and preserving client relationships while potentially optimizing returns. This reduces reliance on non-bank partners, particularly during economic downturns when these partnerships may become strained.

FIGURE 4: SIZEABLE DEMAND FROM DEDICATED SRT FUNDS ACCORDING TO THE ECB

ECB SURVEY BREAKDOWN OF INVESTOR TYPE



Source: Citi Research, ECB, ESRB

5. Source: Bank of America

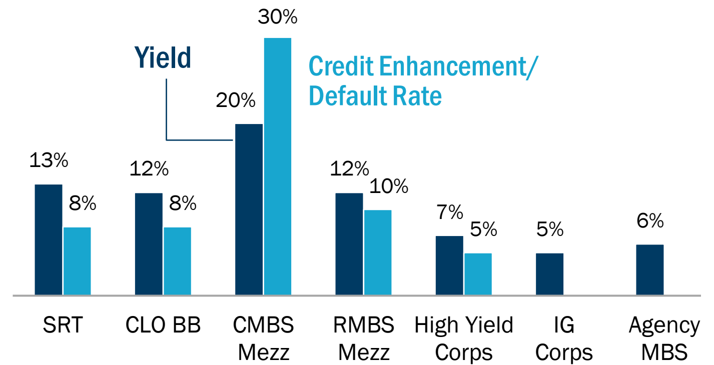
MacKay Shields' Approach to Investing in SRTs

We believe Synthetic Risk Transfers (SRTs) merit consideration as part of a diversified fixed income portfolio. They offer high return potential (Figure 5) due to their private market nature, but with limited liquidity compared to larger fixed income classes like investment-grade bonds (Table 3). We believe there is value in the complexity of SRTs, as they involve complex transactions where thorough research is critical. This includes in-depth analysis of the issuer's financials and transaction structure, such as collateral quality, risk mitigants and features like credit protection and attachment points. We align the maturity of the transaction with the collateral.

Our fundamental research process centers on alignment between the investor's interests and those of the issuing bank. After this analysis, we are better equipped to accurately price a transaction, considering factors like issuer strength and collateral backing. Recent SRT transactions offered yields ranging from SOFR + 8% to 12%, but each transaction is priced based on the specific risk-sharing layers and asset backing. Proper pricing is critical, as recent transactions—particularly in auto loans—haven't always compensated investors for the risks involved.

In essence, our approach focuses on a rigorous investment process seeking attractive return while carefully managing risks. As the US SRT market expands, we believe now is an opportune time for investors to consider adding SRTs to their portfolios, particularly those seeking higher yields and diversification.

FIGURE 5: SRT YIELDS PRESENT ATTRACT RISK-REWARD



Data as of September 2024.
Source: MacKay Shields, Bloomberg, Santander

TABLE 3	Market Size ($BN)	Tenor Year
SRT	**$75**	**5.0**
CLO BB	$50	5.7
CMBS MEZZ	$30	4.5
RMBS MEZZ	$2	5.5
HIGH YIELD CORPS	$1,363	5.0
IG CORPS	$7,300	7.0
AGENCY MBS	$8,740	6.0

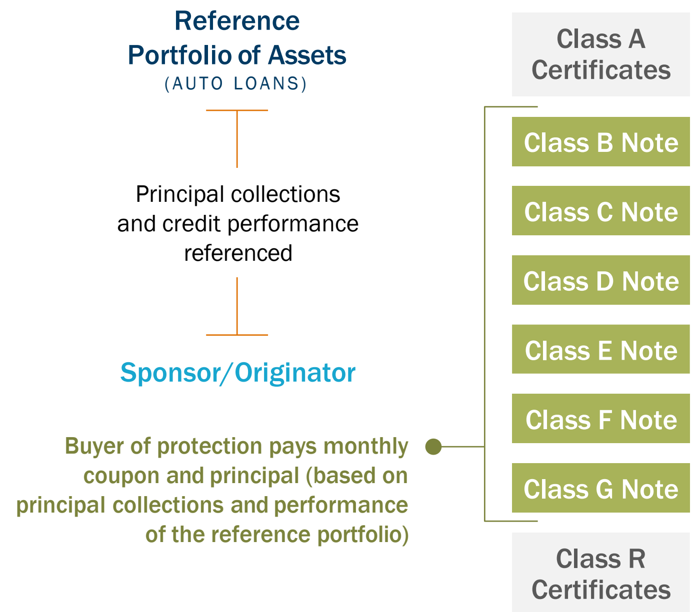
Data as of September 2024.
Source: Bloomberg

Appendix: Credit-Linked Notes (CLNs)

In capital relief transactions, a credit-linked note (CLN) is structured to transfer credit risk from the sponsor or originator, usually a bank, to the noteholders. This transfer is facilitated through a hypothetical financial guaranty or credit default swap. The reference pool of assets, such as auto or student loans, remains on the bank's balance sheet as unencumbered assets, unlike traditional asset-backed securities (ABS) where the assets are sold to an SPV. Investors purchasing CLNs assume the credit risk of the reference pool and in exchange provide credit protection. In the event of a credit event or loss, the sponsor receives compensation from the noteholders while continuing to make regular principal and interest payments on the notes. This structure allows banks to reduce their credit exposure without selling the underlying assets.

When comparing CLN transactions for auto loans with prime auto loan ABS, a key difference lies in asset ownership and risk exposure. In prime auto loan ABS, the underlying auto loans are sold to a special purpose vehicle (SPV), removing them from the issuer's balance sheet. Investors in ABS own the rights to the cash flows generated by these auto loans. In contrast, a CLN does not involve an asset sale; the auto loans remain on the issuer's balance sheet and investors take on the credit risk associated with the reference pool without direct ownership of the assets. As a result, the issuer retains control over the assets in a CLN transaction, while ABS investors have a direct claim on the auto loan cash flows.

FIGURE 6: SIMPLIFIED CLN STRUCTURE DIAGRAM



Source: J.P. Morgan

TABLE 4: Auto CLN versus Prime Auto Loan ABS

Differences between CLN and Regular Auto Loan ABS Transactions

	CLN—Rating Capped	CLN—Cash Collateral + LOC	Regular Auto Loan ABS
ORIGINATORS	Bank	Bank	Captives, Banks, Specialty Finance Companies, Credit Unions
RATING LINKED TO SPONSOR'S UNSECURED RATING	Yes	No (AAA Rating Possible)	No (True Sale/SPV)
SOURCE OF PRINCIPAL PAYMENT	Sponsor/Originator	Cash Collateral Account (Sponsor/Originator in Case of Shortfall)	Collections from Auto Loan Pool
SOURCE OF INTEREST PAYMENT	Sponsor/Originator	Sponsor/Originator (LOC in Case of any Shortfall from Sponsor/Originator)	Collections from Auto Loan Pool
EXCESS SPREAD & OVERCOLLATERALIZATION	No		Yes
PAYMENT WATERFALL	Pro-Rata with Performance Lockout Triggers		Sequential

LOC = Letters of Credit
Source: J.P. Morgan

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