



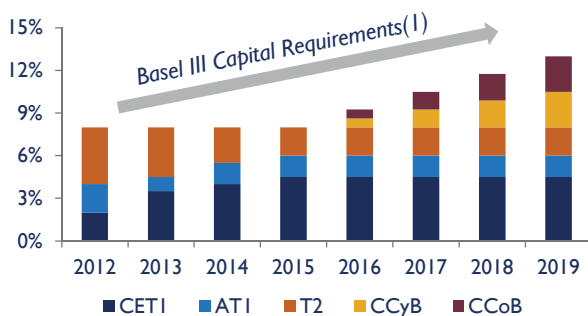
## Regulatory Capital transactions can provide diversification and attractive returns

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Since the Financial Crisis banks have been under intense scrutiny from many angles, in particular from their Regulators. Regulators have sought to ensure that banks are not only underwriting loans appropriately – to ensure good credit quality risk is being originated and a repeat of the US subprime crisis avoided – but also that they hold appropriate amounts of capital against the loans which are made. This has led to changes and enhancements to frameworks such as Basel III and IV.

The tightening of the regulatory environment continues. The next evolution of Basel IV will be enacted between 2022 and 2027. Furthermore, there are additional implications from changing accounting rules such as IFRS9 and CECL. Banks need to keep adapting to an evolving regulatory landscape.

### Banks' Regulatory Capital requirements continue to rise<sup>1</sup>



As bank regulation evolves, Regulatory Capital transactions, officially termed as Significant Risk Transfer (SRT) by Regulators, will be an important part of a bank's tool kit to manage their capital positions in addition to instruments such as ATIs, CoCos and Contingent Capital. SRT transactions are another potential tool that can help them manage their regulatory capital risk via risk sharing of the loans on their balance sheets with a range of institutional investors. SRTs can offer stable and low correlated returns. These transactions use well established securitisation technology. Unlike traditional securitisations, they are not driven by arbitrage motivations, but rather they are risk sharing transactions where the bank and investors are closely aligned and both benefit in different ways.

### What is the Investment Opportunity?

SRT provides an opportunity to work alongside banks, developing close relationships to understand and invest in their core lending businesses such as SME lending, Mortgage lending and Trade Finance. This is a key differentiation of the SRT sector,

whereby banks use SRT to allow them to retain attractive core lending exposures on their balance sheets to manage the capital of their ongoing core business operations where they have a significant market presence and wish to continue to do so. From an investor perspective this is interesting for a number of reasons, i) the opportunity to gain access to otherwise difficult to source assets; ii) the ability to underwrite and understand the bank's core business; and iii) the close alignment of interest of bank and investor is an attractive component of the investment. Importantly, they allow an investor to share risk with a bank in its core loan portfolio, while isolating that investment from general bank risk.

The risk sharing and alignment components have contributed to strong credit performance of these transactions. This in turn means that the risk-adjusted returns offered by SRT investments are attractive and compare favourably to competing opportunities in adjacent sectors. For example, income yields on an SRT transaction are typically in the region of 8 to 12% versus ATIs which typically offer income yields of 4 to 6%<sup>2</sup>. However, the sector is nuanced and the structures can be complex. Banks hold a wide variety of different asset types in a range of different jurisdictions. Add this to the nuances of the deal structuring and it becomes important to have the experience and knowledge to analyse and, importantly, differentiate between different deals in order to select the very best investments and to seek to achieve the best risk-adjusted returns.

### The SRT market is evolving & growing – an attractive entry point

As discussed, the regulatory scrutiny of banks continues. This is driving more changes with respect to how banks will manage their regulatory capital. SRT is an important element of how they manage this challenge and is firmly embedded in their business process. This means in the coming months and years we will see more banks issuing SRT deals and, as the regulatory rules change, banks will use a wider range of asset types. SRT deals are evolving to meet these demands and regulatory rule changes, resulting in yet more types of deals to consider, thereby increasing investment opportunities

Investors equipped with the expertise and knowledge to consider the SRT sector have the opportunity to access attractive stable risk adjusted returns which exhibit low correlation to wider markets and could provide an attractive income producing profile to their portfolio.

Source: <sup>1</sup>The New Basel III Framework: Navigating Changes in Bank Capital Management. PwC's FSI. October 2010. ARP Research.

<sup>2</sup>CQS Research as of 30 June 2019.

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