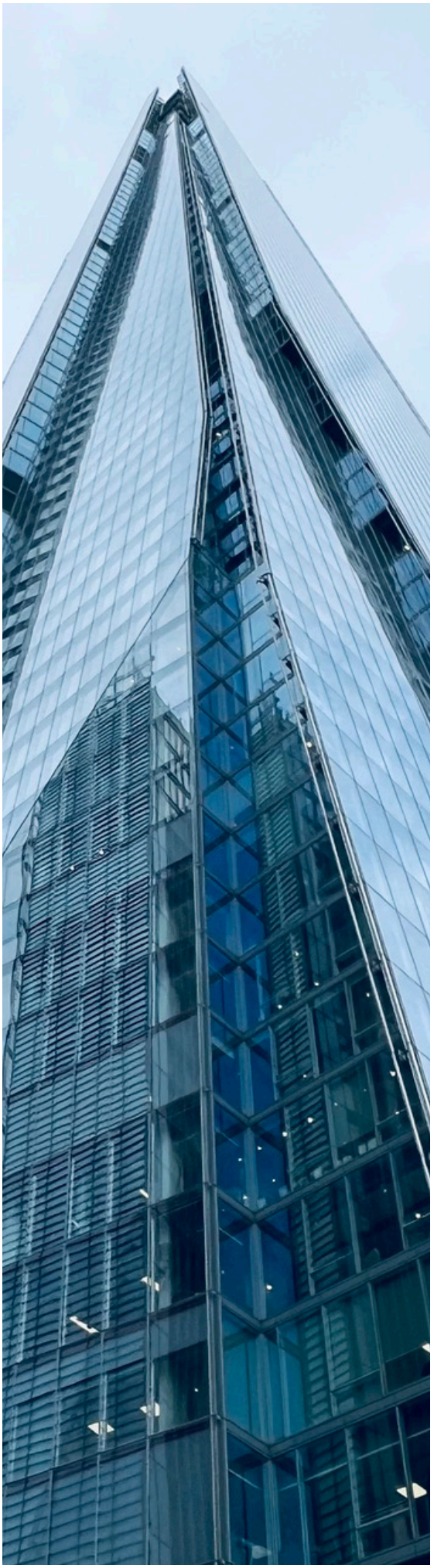
Manulife | CQS
Investment Management

A primer on Significant Risk Transfer ("SRT")

A conversation with
Jason Walker, Co-Chief Investment Officer,
Manulife | CQS Investment Management (MCQS)



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Can you describe the SRT strategy?

SRT is an opportunity to get exposure to the highest-quality parts of global bank balance sheets. Typically, we're referring to tier-one banks that are using SRT transactions to manage their capital position.

How did the bank SRT market come into place?

So SRT was really born out of the global financial crisis when there was a lot more focus on a bank's capital position amid pressure from regulators for banks to not take on excessive risks. That's led to a lot of opportunity and evolution in bank regulatory capital markets. In our view, it's really an opportunity to get exposure to the highest-quality parts of banks' balance sheets in well-run banks. As banks look to manage their capital better, they're identifying positions in their balance sheets that aren't particularly capital efficient. And that often leads them to the highest-quality parts of their loan books.

This is why we often see these transactions being populated by a vast majority of investment-grade risk or high-quality sectors such as revolving credit facilities, for example. This is really interesting to us because it means we're getting this opportunity to get exposure to strong credit quality. But what makes this an even more attractive proposition is that the length that banks are willing to go to achieve capital relief—that is, how much they're willing to pay to free up capital—isn't driven by the quality of the underlying loans themselves, which typically have quite low spreads by virtue of being high credit quality. Rather, they're based on how much capital they can save.

These banks are focused on recycling that capital so they can lend more to high-quality borrowers, leveraging their best relationships. This really creates a very attractive risk-adjusted return from our perspective.

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Your investment team is based in London. How has that made a difference to your understanding of bank SRT?

Members of our SRT team have been involved in the bank regulatory capital market from the get-go, since its inception during the global financial crisis. MCQS has been an investor in this area since 2014.

What that means is that we've seen the market evolve and grow. That's allowed us to build our approach, develop our modelling, our data and analytics regarding how best to approach this market. Crucially, it gave us the opportunity to build and solidify our relationships with banks, which is key to sourcing the very best transactions for investors. Being based in London has certainly helped because we're really in the heart of where bank regulatory capital was born and developed.

I think that really gives us a solid footing and a competitive advantage, enabling us to have solid reach into the most prolific bank regulatory capital issuers and users of the market in the United Kingdom and Europe. As the market develops, we have and will continue to fine-tune our approach and profile.

In addition, we have very strong links with Canadian banks and U.S. banks. We can enhance that further as part of Manulife Investment Management and position ourselves as a highly experienced bank regulatory capital boutique that's part of this large global organization. We can really ensure that we're developing and leaning into existing broad relationships to source the very best deals.

The final but really important aspect, I think, where we can differentiate ourselves is that, oftentimes, bank regulatory capital teams are either part of a pure regulatory capital firm or a pure regulatory capital business within a larger organization. At MCQS, our team sits within the asset-backed securities group, which is fully plugged into the global MCQS alternative credit platform.

And why is that important?

The MCQS alternative credit platform really spans the whole credit spectrum from a liquidity and risk perspective. So, we have a whole range of different strategies from daily and monthly liquidity vehicles, through to longer locked bank regulatory capital mandates and everything else in between.

That gives us a lot of flexibility in terms of the type of risks—or bank assets and loans—that we can look at and how we can structure risk and that's particularly pertinent. What I mean by that is that we have a platform whereby we're investing in bank regulatory capital transactions across the MCQS platform.

That really allows us to create quite a bit of scale and flexibility in terms of how we invest. Firstly, I would note that like all structural credit markets, bank regulatory capital may have different risk profiles within the structure. So that lets us aggregate potential demand for transactions, which really enhances the conversation and the relationship that we have with banks because we can provide a holistic solution to them.

We can place a lower-risk, lower return portion of the transaction to maybe the long-only funds and a higher-return portion into the bank regulatory capital, a locked-up vehicle, as an example. What that allows us to do and how that transforms itself into opportunities from an investment perspective is key.

How are bank regulatory capital deals structured?

Bank regulatory capital deals are issued in one of three ways: either in a bilateral basis, so direct between one investor and the bank, or a small club transaction, maybe three to five investors working with the bank. And finally, some deals are done on a broadly syndicated basis. Our preference is always to work in a bilateral or club transaction.

The reason for that is that we can then really direct what the risk of the transaction is, what the structure of the transaction is, and, of course, the pricing. In a syndicated deal, you inevitably end up being a price taker.

Broadly speaking, can you describe what a SRT transaction or trade might look like?

A bank regulatory capital transaction is where the bank selects a portfolio of its loans—oftentimes, its highest-quality loans from its best customers—and uses it as a way to release bank capital so they can lend even more to those same customers on a go-forward basis.

To get capital relief, what the bank does is buy credit protection, or insurance, if you like, on the losses that may come from that loan portfolio. Typically, they buy protection on the first portion of losses that might come from that portfolio, and that varies by transaction and could be anywhere from the first 5% to 10%, say, for example, of losses that might come from that loan portfolio. Portfolio sizes vary as well, but it could be billions of dollars, in which case the bank is therefore buying protection for 5% to 10% of a billion-dollar portfolio, for example, $50 million to $100 million. That creates a profile of risk that investors can then purchase in a credit-linked note basis.

In return for that, the investor typically receives a return over a benchmark such as the Secured Overnight Financing Rate (SOFR). At the moment, we're seeing returns of around SOFR plus 7% to 10%.[1]

How do bank SRT transactions fit into the broader spectrum of alternative credit?

SRT is a section of the alternative credit market that is increasingly coming to the fore. It's a sector that has really started to develop in recent years in the United States, and both investors and banks are starting to participate in this market.

Bank regulatory capital offers an opportunity to embed high income into your portfolio, but importantly, high income that's supported by strong credit quality. In other words, I see it as a stable income component and an asset that exhibits very low volatility.

I think about it as a bedrock of portfolio construction. It's a volatility buffer and gives me a lot of flexibility within portfolios.

And that's resonating, I think, broadly with investors, regardless of what they might already have in their portfolios because an income component is attractive for many reasons.

What are the attributes that would draw you to a deal, and what do you consider a downside?

The bank regulatory capital market is a very broad market, and banks have different types of assets on their balance sheet. That gives us choice, from an investment perspective. We manage bank regulatory capital from our ABS team and our broader alternative credit platform.

This means we can really look at everything, be it corporate risk, consumer risk, or mortgage risk, for example. We therefore are able to decide and identify investments on a couple of different levels; first, based on our view of different sectors and what's happening in the global economy at different points in time.

Let me give you some examples. In the last few years, I've been more defensive and cautious in terms of the potential for an increase in corporate credit defaults, and we've been much more focused on higher-quality, large-cap corporates as opposed to small and medium-sized enterprises. Further to that, we've avoided some countries. Certain European economies that have turned in a more negative direction—we've avoided those completely.

That said, bank regulatory capital is a structured credit market, so we also think very carefully about what we can incorporate into these deals to help protect against tail risks, especially in light of the growing uncertainty in the markets. So, we focus on including credit protection through structural mechanisms, for example, making sure we have credit support or credit enhancement beneath the risk profile, creating a buffer so that we won't be the first to be affected should some losses occur.

How does your team achieve that, and how do you control the level of risk of each transaction?

We often negotiate with the banks to get them to bear a portion of any potential losses before it would impact us through various mechanisms. We focus very carefully on what I would call tail risk in the portfolio. Recently, we looked at a transaction and identified a tail risk in the commodity sector that we weren't comfortable with.

Since the deal in question was on either a bilateral or club basis with the bank, we asked the bank to remove the exposure that we're not comfortable with. Oftentimes, they will say yes. On this occasion, they were unwilling to. For us, that's a red line and we walked away.

How do you see the bank regulatory capital market over the next three to five years?

It's a really exciting time for the bank regulatory capital market right now. It's kind of been a slow burn since its creation, if you like, in Europe and the United Kingdom, but we've seen some catalysts in recent years. Canadian banks have become quite prolific issuers.

But the really exciting development, as we look forward from here, is that the U.S. banks have really started to talk about and, to some extent, use the bank regulatory capital sector. That's awoken U.S. investors as well. So those two components, I think, are going to potentially bring about some interesting changes in the bank regulatory capital space.

I think it will take a couple of years just to bed in and evolve. The U.S. market in every sector tends to be more transactional than Europe, so I think it will take a little time for U.S. banks to work out how and why they're going to use bank regulatory capital transactions as part of their overall tool kit to help manage their balance sheets.

But I think that will come. I think it's exciting that U.S. banks may be more dynamic in terms of the range of different sectors that they include in these transactions. So, I think that could be an interesting development and could allow us to bring more diversification, you know, different risk profiles into the funds that we run that use bank regulatory capital.

What challenges do you foresee?

The SRT market at the moment really is poised for a lot of growth and that's a double-edged sword. It's going to bring a lot of opportunity, but it'll also bring some risk. We're seeing new entrants come into the market, new banks come into the market. And you know, already we're seeing transactions getting done that we're not necessarily comfortable with from a risk or pricing perspective.

However, that's no different from other sectors or other markets when they start to grow, and it will evolve over the next few years. From our perspective, we've been in bank regulatory capital since 2014. We have a very proven and established investment approach including in-house developed modelling and data-analytics.

And we'll absolutely stick to our approach, and we'll be disciplined on a bottom-up fundamental credit perspective. I think what we'll see in the broader bank regulatory capital market in the next two to three years will be more differentiation in both performance of underlying bank regulatory capital deals by virtue of some of the risks we're seeing but also differentiation of bank regulatory capital managers as the performance of the underlying deal starts to come through in their portfolios.

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1 Structured Credit Investor (SCI) database, as of 2/8/25.

Diversification does not guarantee a profit or eliminate the risk of a loss.

Tail risk is the risk of rare, extreme events causing significant financial losses, lying at the ends of a probability distribution.

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