NASHVILLE NOTES

Synthetic Risk Transfers: Not as Risky as Advertised

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Bloomberg ran a story recently about a synthetic risk transfer transaction in which JPMorgan Chase & Co. sold $2.5 billion of credit-linked notes on a $20 billion reference portfolio that priced in late 2023. The article focused on the risk of other banks providing repo and other forms of financing to investors who purchased the notes. Bloomberg columnist Matt Levine then stirred the pot the next day with an opinion piece entitled "Banks transfer risk to themselves."

Not to be left out, *The Wall Street Journal* followed Bloomberg a week later with its own story on synthetic risk transfers (SRTs).

Five or six years ago I began to review credit-linked notes (CLNs) issued by European and later US banks as part of SRT transactions from the perspective of investors. I was struck by how the market allowed banks to lay off credit loss risk to investors while also providing capital relief by reducing risk-weighted assets.

In the simplest transactions, the CLNs absorb the first loss, though sometimes there are one or more junior tranches that absorb losses first similar to a collateralized loan obligation capital structure. The issuer and investors negotiate the terms. The size of the note relative to the reference portfolio is measured as thickness (for example, 12.5% in the JPMorgan deal). Interest paid on the CLN is based upon a margin over a base rate — Sofr in the US — that can range from mid-single digits to the mid-teens. Other variables include the maturity date, initial replenishment period before amortization begins, prepayment speeds and of course credit losses.

The return to the investor will depend. If losses never amount to much, the investor should realize annual returns running from the high single digits to high teens before factoring in any leverage. In effect, the melting ice cube (i.e., the CLNs) only melts a little bit. If losses are high and sustained shortly after issuance, the CLNs will melt faster and the bank will, in effect, "raise" cheap capital by shifting the losses to the investor.

> ***Looking at credit-linked notes, I was struck by how the market allowed banks to lay off credit loss risk to investors while also providing capital relief.***

Although SRT transactions have been around for a while, Fed comments last year clarifying SRT/CLN structures that may qualify for capital relief transactions should produce more issuance by US banks. Aside from capital relief, the transactions illustrate the key role that capital markets play in bringing issuers and investors together to manage risks and deploy capital to produce returns. The same analogy applies to the insurance and reinsurance markets.

The Bloomberg article included a quote from former FDIC Chair Sheila Bair, who argued that banks should be precluded from providing financing — leverage — to SRT investors because risk stays in the banking system.

Bair's position may be tied to trust preferred securities issued by banks in the years prior to the global financial crisis, in which some banks invested in the senior tranches of trust preferred securities securitizations and then saw the value of the bonds fall when issuers began to defer payments. Bair was not running the FDIC when Silicon Valley Bank, Signature Bank and First Republic Bank failed, but the same logic would imply that a similar absence of net capital was raised when other banks bought debt issued by the three.

> ***Besides JPMorgan, smaller US banks have also issued credit-linked notes recently, with some interesting deal structures.***

Bair's position seems extreme to me as it relates to what should be vanilla repo financing. The argument is that if losses exceed the collateral margin, then the bank lender will absorb losses if the investor does not post more collateral.

But lender and investor can negotiate collateral haircuts that work for both parties. If the CLNs are tied to a higher-risk portfolio such as B-rated leverage loans, then the collateral haircut will be high compared to a reference portfolio tied to residential mortgages. Besides, if a bank sells a loan portfolio to another bank, it is a capital relief transaction for the seller, whereas the buyer has deployed capital. Credit risk remains entirely in the banking system without a nonbank CLN investor buying first loss CLNs, with or without bank-provided leverage.

Aside from large issuers such as JPMorgan, small issuers in the US have included Texas Capital Bancshares Inc., Western Alliance Bancorp. and Merchants Bancorp. Merchant's deal in particular was interesting to me: It issued $158 million of CLNs in March 2023 at Sofr plus 15.5% with a stated maturity of May 2028. The reference portfolio is healthcare commercial real estate loans that presumably entail non-trivial borrower leverage and reimbursement risk. The deal entails a quirk in which the bank absorbs the first 1% of loss, too.

The market for SRTs and CLNs is opaque but not as opaque as it was five years ago. And it is poised to grow rapidly and become less opaque — and more efficient.

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