

INSIGHTS FROM CFA SOCIETY SINGAPORE

How scary are synthetic risk transfers?



ALFONSO RICCIARDELLI

SYNTHETIC risk transfers (SRTs) have recently started raising eyebrows. First introduced in Europe in the early 2000s as a niche form of regulatory capital optimisation, they have since evolved into one of the most important tools in modern bank balance sheet management.

Since 2016, banks have executed SRTs referencing more than US\$1.1 trillion in underlying assets, with annual issuance worth tens of billions of dollars. As activity has climbed, and as private credit funds eagerly absorbed the contracts, regulators and financial journalists have grown increasingly vocal about their concerns.

The question is whether this scrutiny is warranted.

What are SRTs?

SRTs are a form of synthetic securitisation, often called "on-balance-sheet securitisation", in which a bank offloads a portion of a loan portfolio's credit risk through a contract, typically a credit derivative or guarantee, without fully selling or removing the loans from its balance sheet.

In Europe, where the market was born, the investor typically ac-



While synthetic risk transfers are more standardised and transparent than pre-2008 collateralised debt obligations, their bespoke nature and limited public disclosure still make some observers uneasy about assessing the true distribution of risk. IMAGE: PIXABAY

quires mezzanine loan risk by selling (writing) a credit default swap (CDS); in the United States, this is done through a credit-linked note (CLN). The primary protection sellers are public and private credit funds, which are attracted by competitive yields, access to high-quality diversified credit exposures, and the ability to tailor risk via tranches.

Banks pay for this protection because it allows them to transfer part of their loan risk to investors, which in turn reduces their regulatory capital requirements and frees up capital for new lending at a lower cost than raising equity.

The originating bank retains the first loss (junior) tranche. The investor, who does not have specific knowledge of the pool's underlying loans (only generic de-

tails like maturity, ratings and industry), earns a fixed premium or coupon. If defaults in the portfolio occur, the bank absorbs the first loss; the investor covers losses up to the mezzanine tranche limit.

The bank retains the client relationship, loan administration and interest income to maintain "skin in the game", which is a regulatory requirement. But since it shed a portion of the portfolio risk, the bank is permitted to reduce capital against the loans.

SRTs are typically engineered for capital relief and risk management. On the former, Basel capital rules are widely viewed as excessively penalising certain assets. For example, auto loans require disproportionately high capital despite extremely low default rates. SRTs enable banks to reduce risk-

weighted assets (RWAs) by 50 to 80 per cent in many transactions. In addition, by transferring risk without shrinking their balance sheets, banks can reduce geographic, borrower or sector concentration risk.

Where SRTs are growing and why

European banks remain the most active issuers, accounting for roughly 60 to 70 per cent of global issuance. The market has its roots in Europe because it is a heavily bank-centric loan market, with a stringent interpretation of post-global financial crisis (GFC) capital regulations.

A clear supervisory framework and a deep investor base in Europe have also supported its growth. Each SRT transaction undergoes European Central Bank/European Banking Authority review, and recent regulatory rules have rewarded high-quality structures with more efficient capital treatment.

In the US, following the US Federal Reserve's 2023 guidance recognising direct CLN structures as eligible for capital relief, banks quickly entered the market. The US now represents nearly 30 per cent of global deal flow.

In Asia, institutions in markets such as Australia and Singapore have experimented with SRT-like structures, often under different labels or pilot programmes, though volumes are considerably smaller.

Heavy scrutiny

Despite their benefits, SRTs continue to draw significant regulatory scrutiny. Supervisors are most focused on rollover risk, investor

concentration and back-leverage, all of which can become more pronounced as issuance grows.

First, rollover risk arises because SRTs usually mature in three to five years, while the underlying loans often remain on the balance sheet for much longer. If market conditions worsen when an SRT comes up for renewal, banks may struggle to replace the protection, leading to a sudden increase in RWAs and potential pressure to de-leverage.

Second, this risk is amplified by investor concentration; a relatively small group of private credit funds dominate the mezzanine market. Their outsized role means that the entire SRT ecosystem depends on the willingness of a handful of players to refinance. In a stressed market, these funds could demand sharply higher spreads or pull back altogether, leaving banks with limited alternatives.

Third, regulators are attuned to back-leverage. Under Basel III/IV and regional rules (for example, the European Union's Capital Requirements Regulation), a bank must prove that a material share of the portfolio has been transferred, that the transfer is real, and that investors can be protected even under stressed market conditions.

By requiring evidence of material risk transfer and bank skin in the game, the rules aim to prevent regulatory arbitrage through circular transactions and ensure that SRTs strengthen, rather than weaken, the resilience of the financial system.

Finally, concerns about opacity persist. While SRTs are far more standardised and transparent than pre-2008 collateralised debt

obligations, their bespoke nature and limited public disclosure still make some observers uneasy about assessing the true distribution of risk.

Eye on the ball

For banks, SRTs have become a strategic lever to manage capital, mitigate credit exposure, and keep lending volumes intact, with the regulatory environment having been tightened since the GFC.

The public scepticism that surrounds SRTs is, in my opinion, a result of a form of post-traumatic stress from the financial crisis. The main difference this time is that moral hazard is meaningfully lower than in pre-2008. Banks retain first-loss exposure; investors hold real risk; and the overall market remains relatively small.

Rather, SRT issuance is a response to overly conservative risk weights that, in the years following the crisis, pushed banks to limit lending. It is a rational approach to redistributing risk and freeing capital for investment, especially in Europe, where banks are by far the dominant player. To institutional investors, SRTs offer potentially differentiated credit exposure and compelling yield.

This content has been adapted from an article that first appeared on CFA Institute Enterprising Investor, at <https://blogs.cfainstitute.org/investor/>

The writer, a CFA and CAIA Charterholder, holds a CFA Certificate in ESG Investing. He is now enrolled in an Executive Master of Business Administration programme at the National University of Singapore.