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IMF Global Financial Stability Report Staff
Via Electronic Submission

January 13, 2025

Dear Ladies and Gentlemen:

Re: IMF 2024 Global Financial Stability Report

The Alternative Credit Council[1], the private credit affiliate of The Alternative Investment Management Association Ltd (AIMA), would appreciate the opportunity to provide some comments on your most recent Global Financial Stability Report ("GFSR").[2]

We regularly follow the semi-annual GFSR, which always contains interesting data, analysis, and insights into macroeconomic trends and potential vulnerabilities. To our knowledge, this is the first time the GFSR has included a significant discussion of synthetic risk transfers (aka significant risk transfers or "SRTs"). The report correctly notes that since 2016, over $1.1 trillion in bank assets have been synthetically securitized, with two-thirds occurring in Europe. Given that a number of our members are leading practitioners and experts on SRTs, we would like to share some reflections on the six points that the report makes about these transactions. In addition, we would greatly appreciate the opportunity to have a dialogue with you regarding these points and our responses to them.

[1] The Alternative Credit Council (ACC) is a global body that represents asset management firms in the private credit and direct lending space. It currently represents 250 members that manage over US$2 trillion of private credit assets. The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council. ACC members provide an important source of funding to the economy. They provide finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business. The ACC's core objectives are to provide guidance on policy and regulatory matters, support wider advocacy and educational efforts and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits. Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. The ACC seeks to explain the value of private credit by highlighting the sector's wider economic and financial stability benefits.

[2] International Monetary Fund, Global Financial Stability Report: Steadying the Course: Uncertainty, Artificial Intelligence, and Financial Stability (Oct. 2024), https://www.imf.org/en/Publications/GFSR/Issues/2024/10/22/global-financial-stability-report-october-2024.

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Here are some insights and responses in relation to the six concerns about SRTs included in the October GFSR.

1. The magnitude of the interconnections is difficult to assess because the market remains opaque, with only a fraction of deals being made public and no centralized repository for data on SRTs.

Response: While it is true that SRT trades are often privately negotiated between banks and investors and not made available to the general public, banking regulators have more than sufficient visibility into every transaction and have a clear ability to ask for more details from banks if they wish to do so. Additionally, any capital relief taken by a bank in connection with an SRT transaction will be observable under reports of regulatory capital provided under Schedule RC-R of the bank's quarterly filed call reports or Schedule HC-R of a bank holding company's quarterly filed FR Y-9C forms. In the United States, banks will notify their appropriate state and federal bank supervisors prior to establishing an SRT program with investors or otherwise entering into a first-ever SRT trade, assuming the business objective includes some measure of capital relief. These pre-execution discussions provide an opportunity for regulators to raise supervisory concerns, which have included issues around interconnectedness, capital adequacy, and the conversion of credit to counterparty risk, among others. Banks regularly approach those meetings with transaction descriptions and draft transaction documents.

Furthermore, any SRT transaction structured in the form of a direct bank-issued credit-linked note ("CLN") requires an express "reservation of authority" (ROA) approval from the Board of Governors of the Federal Reserve (the "Federal Reserve"), per FAQs that were issued by the Federal Reserve in September of 2023.[3] We also note that asset-backed securitizations in the United States do not require reporting to a central repository, so establishing a reporting system specifically for bank-executed synthetic transactions would be highly unusual.

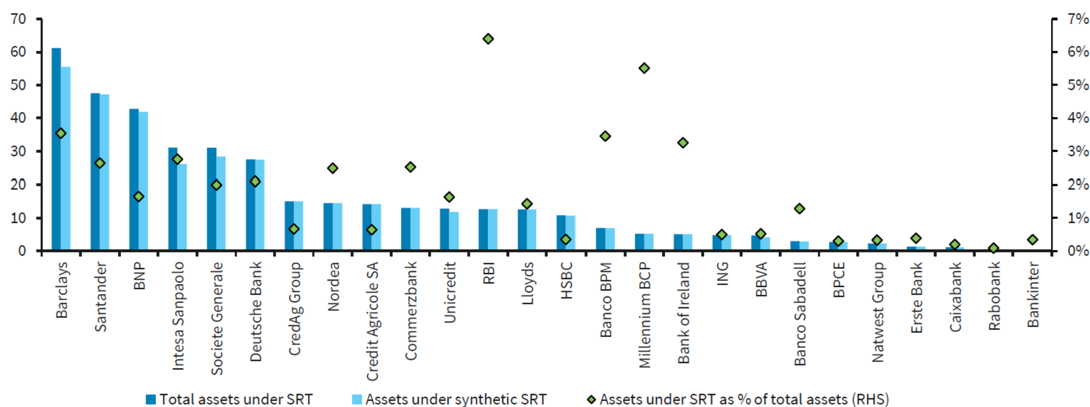
Banking regulators in the EU also have well-developed regulations for the analysis, approval, supervision and surveillance of SRTs. While there is no central repository to which all SRT trades are reported, EU banks are broadly subject to the same requirement as their US counterparts to notify their regulators when executing an SRT trade, though that requirement is more formally codified under Article 7(1) of the EU Securitisation Regulation, which requires all securitization transactions to be reported to "competent authorities." Banking supervisors in the EU have also published numerous industry-wide supervisory guidelines, reports and assessments of SRTs, including the European Banking Authority ("EBA"), the European Central Bank ("ECB"), and the European Systemic Risk Board ("ESRB").

Finally, banks disclose their securitization activity (including on-balance sheet trades such as SRT)

[3] Board of Governors of the Federal Reserve, Frequently Asked Questions about Regulation Q (September 28, 2023), https://www.federalreserve.gov/supervisionreg/legalinterpretations/reg-q-frequently-asked-questions.htm.

in their Pillar 3 reports, which are publicly disclosed. Some news sources even collect that data and aggregate it for all to see, as per the chart below.

FIGURE 4. **Assets underlying SRT transactions (end FY23. in €bn), and these assets as % of total assets**



Source: Barclays, The Rise of SRTs (Sept. 2024)

In response to the specific objection that "banks are providing leverage for credit funds to buy credit-linked notes,"[4] it would be wrong to assume that credit risk being transferred out of the banking system via an SRT trade is returning with the same risk profile, as would be the case if a bank were to directly acquire another bank's issuance of CLNs. For one, any leverage is usually provided on a fully secured, fully margined basis with a significant equity buffer. Investors will effectively absorb losses prior to the deterioration of the bank-provided leverage, providing first-loss protection. As an example, funding banks generally require a 40% haircut with daily margining and a six-month to one-year financing tenor. For a bank to lose money on such a financing transaction, this would require (a) first the credit fund to default and (b) second the market value of the SRT to drop by more than the value of the haircut in just a few days following the default of the credit fund during the financing close-out period. (We note this dynamic reflects a broader macro trend in which banks partner with investors to shift their balance sheets away from unsecured, untranched exposures to safer senior, secured exposures.)

Secondly, any leverage will be subject to the bank's standard underwriting criteria, which would appropriately account for the correlation risk between the bank-provided financing and the underlying SRT transaction. The financing will also be capitalized as per the usual financing capital rules such that any risk taken will be appropriately factored into the bank's required capital. Finally, no bank would ever finance an SRT paper it has itself issued.

2. SRTs may mask banks' degree of resilience because they may increase a bank's regulatory capital ratio while its overall capital level remains unchanged. Increased use of SRTs may reflect an inability to build capital organically because of weaker fundamentals and profitability performance.

[4] GSFR at 45.

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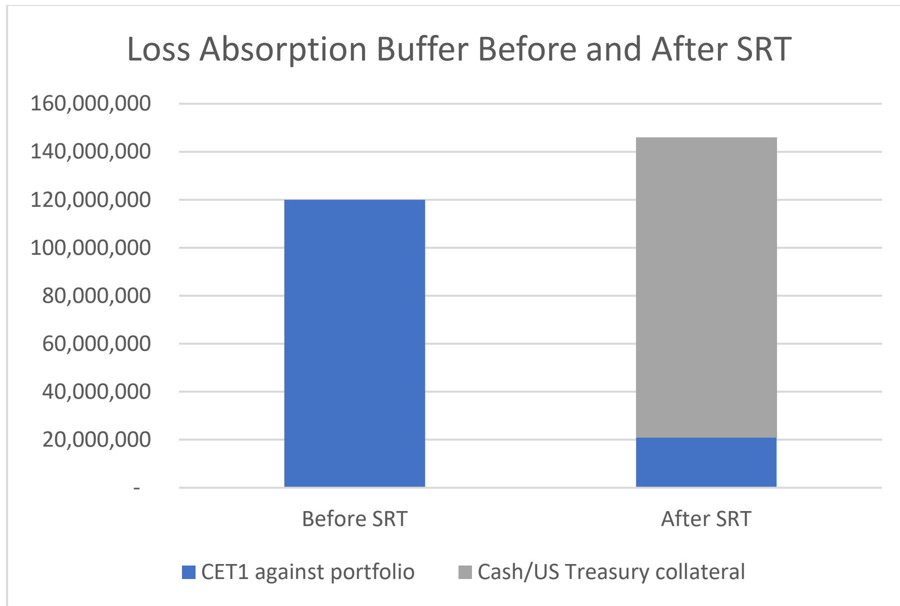
Response: We strongly disagree with this assertion. SRTs can meaningfully improve a bank's regulatory capital ratios, but the means by which they do so is not through an *increase* in the overall level of Common Equity Tier 1 / total capital (i.e., numerator), but rather through a *decrease* in the risk-weighted assets (RWAs) associated with the underlying portfolio (i.e., denominator). This reflects the reality that when a bank executes an SRT transaction, they are purchasing a true credit hedge; investors will bear the risk of a first or second loss on the underlying portfolio, significantly reducing the bank's overall losses as individual loans default. To the best of our knowledge, numerous claims have successfully been made on SRTs. They are typically honored without challenge, demonstrating that these transactions consistently perform in line with their intended expectations. Expecting that a bank's regulatory capital ratio can only increase by growing its overall capital level would effectively mean banks should never enter into any hedging strategy or reduce any type of lending activity to increase its capital ratio.

Furthermore, both the US bank capital rules and the EU Capital Requirements Regulation ("CRR") impose a "securitization surcharge" in the calculation of a bank's RWAs in connection with any securitization exposures (reflected, among other things, by the p-factor in the securitization formula for capital purposes). The effect of the surcharge is magnified when one considers the fact that the retained, senior tranche of an SRT transaction is subject to a RWA floor of 20% in the US and 10-15% in the UK/EU. The net effect is that banks are already over-capitalizing the retained risk on a securitized portfolio.

It would also be incorrect to assume that the use of SRTs is an indication that a bank is unable to raise capital organically. Bank treasurers have correctly viewed SRTs as one option alongside other capital management tools, including de-risking transactions such as whole loan sales and traditional securitizations, as well as issuances of common equity, among others. It would be wrong to assume that the use of any one specific tool is a sign that the bank cannot raise capital organically; the GSFR, for example, does not provide the same critique against traditional securitizations where the bank retains a senior tranche, which functionally achieves the same funding and capital benefits as an SRT trade. We note in particular that SRTs have been recently used to de-risk portfolios of fixed-rate assets amidst a global rate tightening cycle, as selling such assets via traditional securitizations or whole loan sales will require the bank to recognize any mark-to-market losses on the underlying portfolio. This is a transient feature of the global rate environment, and the use of SRTs by banks in such contexts should not be viewed as a sign of distress but rather as an additional tool in the capital toolbox of the bank. We also note that the size of the capital benefit due to US SRT to the bank capital base is so far very low and likely contributes to less than 1%.

From our experience in hundreds of transactions since the 1990's, and confirmed by bank supervisory assessments, SRTs do meaningfully change the bank's overall risk and capital levels. As demonstrated by the illustrative SRT transaction below, a bank's loss absorption buffer changes when it completes an SRT transaction. In this case, the bank increases its high-quality

collateral and capital buffer to protect against any potential losses. Importantly, the increase in its capital buffer occurs immediately and is not contingent upon experiencing some future market development.



This example assumes a $1bn portfolio for a $125m junior note.

3. Furthermore, overreliance on SRTs exposes banks to business challenges should liquidity from the SRT market dry up.

Response: As noted in our response to #2 above, SRTs should be positioned alongside other capital optimization tools used by banks, including raising regulatory capital in the form of issuances of common equity and long-term debt. While investor appetite for SRT transactions currently remains strong and diversified globally, we agree that in a credit downcycle, liquidity in the SRT market could reduce as investors become more risk-averse. We note, however, that even during the height of the COVID crisis, banks were still able to execute SRTs in size. This is also not a challenge specific to SRT, but rather all financial products – in any credit downcycle, the issuance of capital instruments would equally be limited. The risk of the market drying up, however, becomes much less a factor for repeat issuers that have developed a programmatic issuance over time and have transacted with a number of sophisticated investors who have become more and more knowledgeable about the issuer's lending platform. In that respect, the fact that current regulations through the use of CLN or even SPV limit the issuance size or number of investors in a given deal goes contrary to that objective.

Importantly, SRTs can help banks ride out credit crises by enabling them to buy credit protection in advance rather than fire-selling assets during the crisis. In the past, when a bank ran into difficulty, it often looked to sell good quality assets to shore up its capital base. These asset sales were often made at prices below par, so the bank gets RWA relief but P&L losses on perfectly

good assets, so they needed to sell greater volumes to achieve the desired impact on capital. The SRT market can actually act as a stabilizer and allow banks to keep these performing assets by buying protection on them rather than fire-selling.

4. Currently, the asset pools being securitized seem to be of higher quality; however, there are signs of increased concerns regarding the deterioration of asset quality (Figure 1.1.1, panel 3). Financial innovation may lead to the securitization of riskier asset pools, challenging banks with less sophisticated tools for risk management because some more complex products make the identity of the ultimate risk holder less clear.

Response: It is unclear what the report means by "financial innovation" as the instruments through which portfolio credit risk is transferred to investors – including credit insurance, credit default swaps, guarantees, CLNs and risk participations – are varied, *do not* depend on the underlying assets being securitized and have been used for decades globally. If the concern is that the asset pools being securitized in SRTs of recent vintage are of lower overall credit quality, transferring the risk on those asset pools to third-party investors should be encouraged as it improves the overall risk profile of the bank and allocates the risk to those parties best equipped to bear them.

Furthermore, a fundamental feature of SRT transactions is that they are typically fully collateralized with cash or cash-like instruments. For collateralized transactions, the credit risk mitigation framework under the US bank capital framework and EU CRR expressly permits a bank to substitute the RWA charge of an underlying obligor with the RWA charge for the collateral. While the identity of the ultimate risk holder may be relevant to regulators and central banks from a systemic risk perspective, they are not ultimately relevant to the bank that has entered into the SRT transaction as their principal recourse is to the collateral pledged to support the counterparty's obligations, not the counterparty themselves. It is worth noting banks know who the SRT bondholder is since the SRT includes transfer restrictions to preserve confidentiality on the underlying portfolio.

5. Although lower capital charges at a bank level are reasonable, given the risk transfer, cross-sector regulatory arbitrage may reduce capital buffers in the broad financial system while overall risks remain essentially unchanged.

Response: We do not believe that it is correct to state that "overall risks remain essentially unchanged." As an initial matter, with the completion of an SRT transaction, risk has been transferred to other aspects of the financial system with a very different, often with a much greater ability to manage that risk or with a much safer risk profile from a systemic perspective. The analysis should not ignore the important reality that other components of the financial sector have very different funding models—including some with significantly more stable, long-term funding, less leverage, and fewer connections with payment systems or other critical functions that make banks inherently more systemic. Eliminating the ability of the banking sector to offload

capital risk to other financial companies that are very sophisticated and better placed to take on that risk would force banks to reduce their lending activity accordingly. In a world where regulators have asked banks to hold more and more capital to continue their lending activity, we believe disincentivizing them from hedging their lending would only result in a negative outcome for the global economy.

6. Financial sector supervisors need to closely monitor these risks and ensure the necessary transparency regarding the SRTs and their impact on banks' regulatory capital.

Response: This point implies that bank regulators are not already closely monitoring SRTs and evaluating their ability to reduce risk for their supervised institutions. In fact, bank regulators currently do carefully monitor SRT transactions as an essential component of their monitoring and regulation of risk (see our response to #1 above). SRT transactions are reviewed by the Federal Reserve, other federal banking regulators in the US market, and the national banking authorities in Europe, including national banking supervisors, the European Banking Authority, the European Central Bank, and the European Systemic Risk Board.

We hope to be able to discuss these concerns with you in more detail and provide our understanding and experience with SRTs. If you have time available to meet early next year, please contact me at Jkrol@aima.org or Joe Engelhard, Head of Private Credit & Asset Management Policy, Americas, at 202-304-0311 or jengelhard@aima.org.

Yours sincerely,

Jiří Król
Global Head of Alternative Credit Council