

Fund Finance Friday



Two Notable Reports Advance the Credit Risk Transfer Conversation

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Two recent reports—one by the **IMF** and another from the **Philadelphia Fed**—assess credit risk transfer (CRT) transactions and conclude that the product serves as a useful tool in reallocating credit risk and optimizing risk based capital costs for banks. Both report that banks are leaning on CRTs to move portfolio credit risk, free capital, and sustain lending growth.

Globally, more than \$1 trillion of reference loans have been synthetically securitized since 2016, with North American activity now rising alongside Europe. In the U.S., issuance accelerated after the Federal Reserve's 2023 FAQ, with the Philly Fed documenting a substantial pickup and a market mix in which roughly two-thirds of outstanding deals are bilateral credit default swaps (CDS) rather than note-funded structures.

Both pieces unpack how CRTs work and why they can be capital-efficient when well designed. Transactions typically transfer the first 12–15% of losses on a loan pool, either through fully funded credit-linked notes or, in some cases, unfunded protection; in the funded case, investors pre-post cash that the bank returns if losses don't materialize. Under U.S. capital rules, effective transfer can reduce risk weighted assets and materially improve return on risk-adjusted capital, illustrated by the Philly Fed's simple return on risk-adjusted capital example. The IMF's framework shows how tranche thickness and portfolio type drive the amount of capital relief.

Both analyses add qualifiers. The IMF concludes that stronger post-GFC prudential regimes and the still-modest market size have, for now, contained stability risks but it flags the potential for vulnerabilities from rapid growth, rollover risk, and the possibility that leveraged investors weaken standards. These risks, it argues, require close supervision, robust reporting, and transparent disclosure. The Philly Fed underscores data gaps (U.S. totals are estimated from supervisory and vendor sources), counterparty risk in unfunded trades, and channels of interconnectedness—such as banks selling protection to other banks or financing investors' credit-linked note purchases—that can pull risk back into the banking system.

Both papers illustrate that "SRT" (synthetic risk transfer) may be winning as the product label competition at the moment even though the transactions are not unified by their synthetic nature—cash transactions are possible—but instead by the risk transfer function. Time will tell. The work of Cadwalader partners Chris Horn, Jed Miller, Andrew Karp and Ivan Loncar in "**Credit Risk Transfers (CRTs): A Handbook for U.S. Banks**" served as a resource and earned citations in both reports.