

Fund Finance Friday



Regulation Q and You: Capital Relief Trades for U.S. Banks

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Over the last 18 months, we've seen a sharp uptick in inquiries from U.S. banks about how to use capital relief trades to manage regulatory capital constraints. Here, we set out our responses to some of the frequently asked questions we've received on this topic. If you're interested in learning more, we invite you to listen in to our free four-part webinar series on capital relief trades (topics and replay links are included at the bottom of this article).

What is regulatory capital?

Every U.S. bank^[1] is required to hold a minimum amount of capital to absorb losses. U.S. bank capital rules, which are codified in a federal regulation known as Regulation Q,^[2] require a minimum amount of capital under both a leverage ratio, which is generally calculated as capital over a bank's total assets, as well as a risk-based ratio, which is generally calculated as capital over a bank's risk-weighted assets (or "RWAs").^[3] In this article, we refer to bank capital requirements under the risk-based ratio as "risk-based" capital requirements.

What are capital relief trades?

Bank capital requirements are intended to minimize the likelihood of bank insolvency. However, holding regulatory capital can be costly for banks, and for a bank that is capital-constrained, it may make sense to explore a capital relief trade, which, as the name suggests, is any transaction that has the effect of optimizing a bank's regulatory capital profile – in particular, as it relates to *risk-based* capital. Capital relief trades can be used for other reasons as well, such as managing credit risk. In the fund finance context, these transactions can also help a bank manage portfolio-level concentration limits, such as a cap on single-sponsor exposure, while retaining those existing lending relationships.

Capital relief trades go by many names, such as credit risk transfer, significant risk transfer and risk-sharing. The acronyms "CRT" and "SRT" are commonly used to describe these trades, although in our experience, "CRT" appears to be the preferred nomenclature in the U.S., whereas "SRT" is more common in the international market.

What do CRTs look like?

In general, all CRTs share three common features. First, a bank must transfer the credit risk associated with its RWAs to one or more third parties. Second, that transfer of credit risk must be effectuated on a tranching (*i.e.*, senior/sub) basis, with the bank transferring the subordinate (*i.e.*, first-loss) tranche of credit risk and retaining the senior (*i.e.*, second-loss) tranche. Third, the investors acquiring the first-loss tranche of credit risk must do so on a collateralized or funded basis.

So long as a CRT contains these three features, it can be structured in any number of ways, each of which has its own pros and cons. The most basic way to group CRT structures is between bilateral and multilateral CRTs. Bilateral trades include credit default swaps and financial guarantees; multilateral trades include various securitization products.^[4] Bilateral CRTs may be easier to negotiate since there is only one counterparty, but multilateral CRTs may offer benefits as well: syndicating credit protection to a wider universe of investors and issuing CRTs in a securities format that can be easily leveraged (for example, by repo) may result in more competitive pricing.

Multilateral trades can be in the form of cash or synthetic securitizations. In order to recognize a capital benefit from a cash securitization, the bank must be able to derecognize the securitized RWAs for GAAP purposes. This requirement – which has become harder to fulfill as a result of certain post-financial crisis changes to the GAAP rules – does not apply to synthetic securitizations, which may be an advantage to using the latter structure. Synthetic securitizations, which do not require assigning RWAs into an SPV, may also be cheaper and less administratively burdensome than cash securitizations.

Synthetic securitizations involve the issuance of credit-linked notes (or “CLNs”) by either the bank or a newly formed SPV. In the U.S., synthetic securitization CRTs have been predominately in the form of bank-issued CLNs, and while SPV-issued CLNs have been widely used in SRT transactions outside the U.S., that market is also migrating toward the bank-issued CLN model. When compared to bank-issued CLNs, SPV-issued CLNs raise additional regulatory issues, such as Volcker, commodity pool operator registration and CFTC swap regulation. Those additional regulatory issues can be addressed with proper structuring, but we note that the SPV-issued structure also generates additional costs and expenses, such as those associated with forming and administering an SPV. Further, CRT investors have generally not required that U.S. banks utilize SPVs, presumably because most issuing banks have credit profiles that are better than those of the first-loss positions being synthetically securitized (and therefore investors do not require an SPV to isolate the CLN issuance proceeds from the estate of the issuing bank).

What capital benefits does a CRT provide to a bank?

CRTs can provide banks with substantial risk-based capital relief by converting loans and other RWAs into “securitization exposures.” For this purpose, Regulation Q takes a principles-based approach: any transaction that transfers credit risk on a tranching basis can be a “securitization,” even if the transaction in question isn’t in the form of a securitization. So, for example, all of the different types of CRTs described above – including credit default swaps and financial guarantees – could be “securitizations” for Regulation Q purposes, provided they embody these substantive economic principles.

A CRT involves a bank transferring a first-loss tranche of the credit risk associated with its RWAs to one or more third parties, while retaining a senior tranche of that credit risk. Depending on the particulars of the structure – and assuming no currency or maturity mismatches between the CRT and the RWAs – the first loss tranche of the CRT could receive a 0% risk weight, and the senior tranche could receive a risk weight as low as 20%. For example, a \$1 billion loan portfolio with a 100% risk weighting (assuming an 8% regulatory capital requirement) would have \$80 million of associated regulatory capital (\$1 billion x 8% x 100%), but if that portfolio were synthetically tranching into first-loss and senior risk positions with \$125 million and \$875 face amounts (*i.e.*, 12.5% tranche thickness for the first-loss tranche), the regulatory capital associated with the portfolio could be reduced to \$14 million (\$875 million x 8% x 20%). In that example, the first-loss tranche would have \$0 of associated regulatory capital (\$125 million x 8% x 0%).

What kinds of RWAs are eligible for CRTs?

Any “financial exposure” can be synthetically securitized for capital relief purposes. This would include certain fund finance products (such as capital call subscription facilities), as well as corporate loans, commitments, receivables, derivatives, debt and equity securities, and mortgages. Depending on the RWAs in question, it may make sense to structure the CRT with a dynamic reference portfolio that allows the bank to substitute, remove and add RWAs (subject to a pre-defined set of asset- and portfolio-level criteria) over a specified replenishment period.

Are there other specific terms that a CRT must contain?

Regulation Q prescribes a number of terms that must be present in any CLN or CDS transaction. These include required credit events and settlement and valuation terms, as well as guidance around what to do with the cash proceeds from the CLN issuance (or, in the case of a CDS, cash collateral). Regulation Q also identifies a number of terms that a CLN cannot have: for example, all clean-up calls must be “eligible” clean-up calls (*i.e.*, exercisable at a 10% threshold), and the CRT cannot contain terms designed to protect or benefit the CLN investors if the credit profile

of the RWAs deteriorates. Such “credit-negative” investor protections would include an increase in the CLN coupon, the right to put the CLNs back to the issuing bank or favorable adjustments to the attachment or detachment points.

What other legal and regulatory issues are relevant to CRTs?

Structuring a CLN will require navigating various U.S. legal issues, including tax treatment, Commodity Exchange Act issues, Dodd-Frank risk retention and insurance regulation. However, probably of most interest to issuing banks is the degree of disclosure that must be made with respect to the RWAs. In tension here are the confidentiality terms and the proprietary nature of the RWA documentation, on the one hand, and the anti-fraud provisions of federal securities laws, on the other. Any CLN issuer will have to carefully craft disclosure that balances these two concerns, while also disclosing any relevant risk factors. Finally, we note that if the CLNs are to be issued to offshore investors, it may also be necessary to consider the impact of EU, UK and/or Japanese securitization regulations.

All of this should give you a good introduction into CRTs.

For further learning, the webinar replays are available here:

- Part 1: **CRT Overview and Regulatory Capital Basics**
- Part 2: **Unpacking Regulation Q: CRT Structuring**
- Part 3: **U.S. Legal and Regulatory Considerations**
- Part 4: **A Practical Guide to Capital Relief Trades for UK and EU Deals**

[1] In this article, we use the term “bank” to refer to both banks and bank holding companies.

[2] 12 C.F.R. Part 217 (Regulation Q is the Federal Reserve’s capital adequacy regulation. The FDIC and OCC have practically identical capital adequacy regulations under 12 C.F.R. Parts 324 and 3, respectively). Under Regulation Q, the largest U.S. banks are subject to a capital methodology known as the “advanced approach,” whereas smaller banks are subject to the so-called “standardized approach.” The capital relief strategies described in this article are available under both approaches.

[3] RWAs will generally include all assets owned by a bank. For purposes of determining the risk-weighted amount of an RWA, the amount of the RWA will be subject to a risk multiplier (or “risk weight”). In general, RWAs that regulators believe to be low risk will have lower risk weights (and therefore less associated risk-based regulatory capital), and RWAs that regulators believe to be high risk will have higher risk weights (and therefore a greater amount of associated risk-based regulatory capital).

[4] Participation structures can also be used for capital relief, and can be either bilateral or multilateral.