

CADWALDER

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 ($\$1 \text{ billion} \times 8\% \times 100\%$), 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 ($\$875 \text{ million} \times 8\% \times 20\%$). In that example, the first-loss tranche would have \$0 of associated regulatory capital ($\$125 \text{ million} \times 8\% \times 0\%$).

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.

Re-member Where the Register Is! Why the Location of the Cayman Register of Members Is Relevant to a Lender's Security Package

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By **Georgina Pullinger**
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As we are moving further into the realm of Fund Finance 2.0 and the rise of the NAV facility, there has been a lot written about taking security over the equities of various types of Cayman entities, particularly Cayman exempted limited partnerships and Cayman exempted companies ("CayCos"). Here we look at additional considerations when taking security over shares in a CayCo ("Cayco Security") in cases where the register of members ("ROM") is maintained in a jurisdiction other than the Cayman Islands or the United States (a "Third-Party Jurisdiction").

What is the relevance of the location of the ROM?

To set the scene:

- One quirk of Cayman law is that the ROM is (in most circumstances) definitive of share ownership.
- Another quirk is that the ROM does not have to be maintained in the Cayman Islands. Most commonly, the ROM is (i) maintained by the registered office or an administrator within Cayman or (ii) maintained by an administrator in the U.S. (we will refer to any entity that maintains a ROM as an "Administrator" for the purpose of the article). With the continual growth of the fund finance market and the diversification of fund structures and borrowers, however, we are increasingly seeing ROMs maintained by Administrators in Third-Party Jurisdictions (a "TPJA").
- Cayco Security is usually governed either by Cayman law, or in the context of a wider U.S. law transaction, the applicable U.S. law (usually New York.)
- In an enforcement situation, to effect a share transfer the ROM must be updated by the Administrator to reflect the secured party (or its nominee) as the shareholder.

The combination of the above points means that a secured party could end up in a situation where it has a Cayco Security governed by Cayman or U.S. law but needs to take that security to a TPJA to have the ROM updated to effect a share transfer upon enforcement. The question then arises: can the secured party be confident that the share transfer would take place in a timely manner? Will the TPJA respect and follow the share transfer instructions in relation to an enforcement action?^[1]

In addition to the practical aspects of enforcing Cayco Security in a Third-Party Jurisdiction, there is a fundamental legal question as to the applicable governing law of the security in the case of Cayman shares where the ROM is held in a Third-Party Jurisdiction. As a general rule, the law of the place of incorporation of a company (in this case, Cayman) decides how the shares in a company may be transferred; given that shares in a CayCo can only be transferred by registration on the ROM, those shares will generally be regarded as situate at the place where the ROM is maintained. Why does situs matter? Although the position is not entirely free from doubt, the more commonly held view is that situs determines the proprietary aspects of a security interest (that is, the steps required to perfect a security interest in the Cayman shares). We could go into a much longer analysis as to the applicable governing law of CayCo shares where we have a TPJA, but for the purpose of this article, it is just worth noting that, from a legal and governing law perspective, the Third-Party Jurisdiction of the ROM should always be considered and that, in some cases, additional local law actions might be required in the Third-Party Jurisdiction (for example, additional local law perfection steps).

The various approaches to a TPJA

Whether any additional steps should be taken when a ROM is maintained by a TPJA will depend on a number of factors, including the Third-Party Jurisdiction, the relationship between the applicable parties (*i.e.*, the lender, borrower and pledged entity), the TPJA's understanding of Cayman security and familiarity with the jurisdiction, and the commercial agreement between the parties as to the risk analysis in the event that parties end up in an enforcement situation. We have seen varying levels of additional lender protections, from no additional action being taken through to additional perfection steps in the Third-Party Jurisdiction and even additional local law security being taken in the Third-Party Jurisdiction.

There is no one-size-fits-all approach to addressing these considerations, and we are certainly not suggesting that a TPJA will necessarily cause issues for a transaction or cannot work from a secured party perspective. But it is something to be mindful of, particularly as we see increasing numbers of more unusual fund structures. We would recommend seeking input from local counsel in the Third-Party Jurisdiction, particularly as to whether any additional perfection steps might be required.

Cayman security is generally a well-trodden path, but there are certainly quirks and considerations that will come to the forefront as the borrowers and fund structures continue to diversify and also as new lenders enter the market with fresh eyes and often new approaches to risk profiles. We look forward to providing ongoing updates as to new commercial trends and considerations that we are seeing as the market continues to develop.

[1] Just to highlight that we are not generally concerned with any combination of Cayman/U.S. law governed CayCo Security and Cayman or U.S. Administrators – these jurisdictions work well together, are familiar to each other and there is a history of these structures being effectively enforced between the jurisdictions.

FFA APAC Fund Finance Market Update

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Find out the latest APAC Fund Finance market updates from the experts themselves at the upcoming virtual panel discussion hosted by the FFA's APAC Executive Committee on June 22 from 3-4 p.m. More info is [here](#).

PE Firms Set Sights on Retail Investors – WSJ

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These are trying times for the old 60/40 portfolio. *The Wall Street Journal* this week highlighted a pivot among PE firms to court retail investors after firms have successfully convinced pension and sovereign wealth funds to up private market allocations. Rather than an across-the-board increase in high-net-worth investors, a greater retail presence may show up mostly in permanent capital vehicles, such as evergreen funds or BDCs, engineered specifically with individual investors in mind.

U.S. households held \$50.0 trillion in equities at the end of 2021, an all-time high. The share of household investments allocated to equities also reached a record high. The data suggests that greater investment diversification into alternatives may be appropriate. (As a side note, household equity allocation has a good track record as a negative predictor of stock market performance.) *The Wall Street Journal* report is available [here](#).

Investec on Capital Calls by Private Funds

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Investec examines how, despite the increased use of subscription credit facilities in private equity, there has been a stark drop in the average number of capital calls made per fund since 2015, according to recent data. Click [here](#) to read the full report, which includes: the industry trends potentially responsible for the decline in capital calls, how the use of subscription credit facilities has evolved, and predictions for the future of capital calls and subscription credit facilities.

Private Funds CFO Article on NAV Due Diligence

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Private Funds CFO this week published an article on the due diligence requirements of lenders in NAV facilities, available [here](#).

Unquote Article on Pemberton NAV Financing

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Unquote published an article this week on Pemberton's entry into NAV financing. The subscription-required article is accessible [here](#).

Cadwalader Welcomes New FF Team Members

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Renee Fischer



Harry Maidman



Elizabeth Oblachinski

We are very pleased to welcome several new team members to our Fund Finance group and our firm. We look forward to their contributions as part of our growing practice.

Joining the firm recently are:

- **Renee Fischer** (Counsel, New York): Renee's practice focuses on fund finance, including fund of hedge fund, master/feeder and single manager hedge fund leverage, management fee lines, secondaries financing, NAV facilities, subscription lines and hybrid transactions. Prior to joining Cadwalader, Renee worked in both Structuring and Trading at Bank of America and holds Series 7 and Series 63 licenses. She also worked as head of legal for Fund Linked Products, Ultra High Net Worth Lending and Private Bank Lending at Credit Suisse, head of Legal for Fund Derivatives at BNP Paribas and as an associate in Linklaters' Cross Border Asset Finance and Banking teams in New York.
- **Harry Maidman** (Associate, New York): Harry's practice focuses on representing banks and other institutional lenders in a wide variety of fund finance transactions. Harry obtained his J.D. from the Fordham University School of Law.
- **Elizabeth Oblachinski** (Associate, Charlotte): Elizabeth represents banks and financial institutions as lenders and lead agents in structuring, negotiating and documenting subscription credit facilities for private equity funds. Elizabeth received her J.D. from the University of North Carolina School of Law.