

Banks Eye Transfer Deals To Lower CRE Risk

Many regional banks are exploring synthetic risk-transfer deals designed to reduce capital charges and to alleviate regulatory pressure tied to outsize commercial real estate portfolios.

Market players say the institutions have been making inquiries since last year as pressures started building, though talks would pause when conditions looked to be improving. Now, there is a growing belief that the deals finally will come.

“An increasing number of regional banks, particularly those with complex capital issues, are considering capital solutions,” said **Stuart Goldstein**, co-head of **Cadwalader’s** capital-markets practice.

Cadwalader partner **Jed Miller**, who has interacted with regulators on the transactions for years, noted that the level of interest is growing. “Our expectation is that we will see more banks executing this year and next,” he said.

Stefanos Arethas, head of commercial real estate finance for **Atlas SP Partners**, said he has had talks with numerous banks looking to use credit-risk transfer to manage commercial real estate risk. But he downplayed the suggestion that there will be a vast transfer of exposure to weaker loans.

“The notion that there is all this stress out there and that issuers will use [credit-risk transfer deals] to transfer problem loans to the private market is a myth,” he said. “CRT should be viewed as one tool in the toolbox that allows banks to retain assets on balance sheet and maintain client relationships and bring in new third-party capital. It’s a slow, methodical repricing to the current interest-rate environment.”

The mechanics of such deals are relatively simple. An investor acting as a seller of insurance-like protection deposits cash in the amount of total potential losses with either the holder of the loans or a third party. The bank continues to service the loans and pays interest to the protection seller on that deposited



money, akin to an insurance premium.

In the event of losses, however, the bank is made whole and stops paying interest on the amount of the deposit that is wiped out. If no losses occur by the end of the agreed-upon term, the

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full deposit is returned.

Market players involved in CRT discussions said that while many regional banks like the private nature of the transactions — allowing them to avoid dangerous headlines such as those that helped accelerate some bank failures last year — the loan portfolios they plan to reference are relatively pristine.

In fact, portfolios of loans backed by troubled office buildings or other distressed assets likely would be far too expensive to sell risk on, the sources said. One CMBS investor said he believes there is plenty of appetite for the deals and many good reasons for banks to do them other than to shed bad collateral.

“Even if you have to pay an investor 10% — and I’m just quoting a round number — that is a lot cheaper than raising equity or selling assets,” he said. “But I would say there is not a great market for your distressed assets.”

The only bank believed to have done a risk-transfer trade backed by private-label commercial real estate loans is **Merchants Bank of Indiana**, and it did so to free up capital to do more lending. The deal issued last year referenced a \$1.2 billion portfolio of performing multifamily bridge loans destined for agency takeouts (MBHC 2023-CL1), with about 15% of first losses sold off.

New York Community Bank considered using the risk-transfer strategy when its shares tanked over a sagging real estate portfolio, but it instead found a deep-pocketed buyer in a group led by former Treasury Secretary **Steven Mnuchin**.

The Merchants Bank deal was structured as tradable notes issued via a special-purpose vehicle set up by the bank, but others are exploring even more hush-hush offerings that utilize credit-default swaps and are negotiated privately with one or several investors.

As in Europe, where such deals are more common, U.S. banks are looking for significant savings on capital charges applied by regulators without removing assets from their books. Transferring the bottom 12.5% of credit risk in a synthetic trade can lead to an 80% reduction, possibly slightly more, to the risk-based capital attributable to the synthetically securitized assets, Miller said.

And since regulators don’t distinguish between stronger and weaker assets, there is little incentive to offload distressed risk. Market players believe any risk-transfer deals referencing commercial real estate portfolios will be picked over in much the same way B-piece buyers select assets in conduit deals.

Large banks such as **JPMorgan Chase** and **Citigroup** have used the strategy to offload billions of dollars of risk tied to auto loans and jumbo residential mortgages after U.S. regulators acquiesced to their use and issued Regulation Q in 2013 laying out some of the ground rules.

Interest broadened, however, after the **Federal Reserve Bank of New York** last September issued guidance that lawyers believe drew enough bright lines to get bank executives comfortable.

“As capital-management strategies, these trades have been endorsed by the regulators,” Miller added, referencing the express mentions of “synthetic securitizations” in Regulation Q, the recent guidance and “reservation of authority” approvals the New York Fed started giving certain credit-linked note transactions last fall — none of which have been tied yet to commercial real estate.

Although regulators have been increasingly vocal about commercial real estate exposures, market players say they have been patient about applying pressure on banks to offload them. They believe that will start to change this year, however, hence predictions of an uptick in deal volume.

“Regulators are cracking down on the loan books of some of the smaller regional banks,” said another CMBS investor who expects dealflow to pick up. “The solution they are being presented is CRT trades.” ❖

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