Plumb job: can Basel III unblock US credit risk transfer?

Deals from G-Sibs have slowed in recent years due to regulatory confusion over capital relief

By Philip Alexander

@FinRegPhilip

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NEED TO KNOW

- Credit-linked note issuance from the largest US banks has slowed to a crawl, even as regional lenders have completed a series of transactions that have significantly reduced their risk-weighted

assets.

- Legal sources blame the dearth of deals on the New York Fed's strict interpretation of Regulation Q, which governs bank capital requirements
- Large banks are hoping the Fed will clarify the rules on credit risk transfer deals as part of its implementation of the final package of Basel III reforms.
- Bank capital requirements are expected to rise if regulators push ahead with plans to eliminate the use of internal models for credit risk. A revival of the CRT pipeline could partially offset the impact on lending.

For the largest US banks, issuing credit-linked notes (CLNs) on their loan portfolios has become rather too nail-biting of late. But that could be about to change. In banking circles, hopes are rising that the US implementation of the final Basel III rules could pave the way for more credit risk transfer (CRT) deals to hit the market later this year.

"There is some optimism that [the Basel III package] is actually going to help out with some of these interpretive issues we've had," says Gareth Old, a partner in the structured finance team at law firm Clifford Chance, who has advised on multiple CRT deals in recent years.

Those "interpretative issues" relate to Regulation Q, which governs bank capital requirements. To obtain capital relief from CRTs, banks must get confirmation from their supervisors that the deals comply with the relevant part of the regulation. The hitch is that while Reg Q recognises deals that use credit default swaps or financial guarantees to transfer credit risk, there is no explicit mention of CLNs, where credit risk is transferred in the form of a write-down clause that allows principal

repayments to be reduced if defaults in the issuer's loan portfolio exceed a certain threshold.

Banks are automatically granted capital relief on deals that directly match the wording of Reg Q, while those that fall outside the regulatory definitions are reliant on the supervisor's discretion.

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Three sources tell *Risk.net* that the New York Federal Reserve, which supervises five of the eight US global systemically important banks (G-Sibs), has drifted towards a more conservative interpretation of Reg Q. At least three large banks – sources identified Citi, Goldman Sachs and JP Morgan – are said to have postponed plans to issue CLNs in recent months due to uncertainty over supervisory approval.

All three banks declined to comment, along with the New York Fed.

Other regional Feds have been more receptive to CLNs. Texas Capital Bank, which is regulated by the Dallas Fed, issued what it believed to be **the first CLN by a US regional bank** in 2021. Since then, other regional banks, including **Western Alliance** and **PacWest** – both supervised by the San Francisco Fed – have followed suit. The latest deal, **a $158 million issuance** in March, involved Merchants Bank of Indiana, a state-chartered lender regulated by the US Federal Deposit Insurance Corporation (FDIC). By contrast, CLN issuance by G-sibs has been comparatively quiet over this period, with no major deals reported.

The lack of deals from large banks has left some scratching their heads.

"That's maybe surprising, because you would assume the G-Sibs have greater expertise to structure and manage complex transactions like these," says one industry source.

Others suggest differing interpretations of Reg Q among the 12 regional Feds may be holding back issuance. "They work pretty hard to try to co-ordinate with the Fed Board in Washington so there is consistency, but with that many moving parts, there can be times where there is inconsistency," says Daniel Meade, a bank regulatory partner at law firm Cadwalader, Wickersham & Taft.

He sees the Fed's implementation of the final Basel III reforms as an "opportunity to add clarification" on the treatment of CRT deals. "That would fit within what Fed vice-chair [Michael] Barr has said in terms of doing a **holistic review** of the US capital regime."

The revisions to the capital rules have been **delayed** due to the banking crisis in March, and are now expected to be published in July. Meade notes that implementing Basel III remains the Fed's priority, and any movement on CRT may come separately from the main package of reforms.

Letters of credit

CRTs allow banks to reduce capital consumption by transferring the credit risk of a portfolio of loans to a third-party. They come in two main flavours: bilateral trades using credit default swaps or financial guarantees; or securitisations, structured either as tranched pools of CDSs or as CLNs.

To qualify for capital relief, deals must be structured in accordance with US regulatory capital rules. A properly structured deal can generate significant capital benefits. For instance, riskier residential mortgages and loans secured by commercial real estate are assigned a 100% risk-weight

under US standardised approaches to credit risk capital. This can be reduced to 20% by transferring 12.5% of the asset portfolio to an investor. For high-quality mortgages, which carry a 50% risk-weight, the same outcome can be achieved by transferring just 5% of the portfolio.

The capital savings can be even greater if certain conditions are met. At the heart of the CRT rules in Reg Q is the idea of substitution. When a bank transfers the credit risk of a loan portfolio to an investor in a collateralised transaction, the risk-weights of the counterparty and collateral are substituted for the risk-weighted assets (RWAs) assigned to the original portfolio.

In the example above, if the CRT is in the form of a CDS or financial guarantee that is marked-to-market and margined daily, the risk weight can fall to just 10% if US Treasuries are posted as collateral, or 0% if the collateral is in the form of cash deposited at a third-party custodian.

[CLNs are] more liquid than a bilateral credit default swap

Jed Miller, Cadwalader

But Reg Q does not specifically address CLNs, where banks collect the proceeds of the note sale up-front. Several large banks have written to the New York Fed to seek clarification on the treatment of such deals. Sources say the response has been that any capital relief will be at the discretion of supervisors.

That has prompted G-Sibs to stick to bilateral trades that transfer credit risk via CDSs or financial guarantees. The universe of potential counterparties is more limited compared to CLNs, and bilateral deals are rarely made public. “There are some investors and some banks which like that model,” says Old. “They are going to be doing those transactions and

you’re probably never going to hear about them.”

CLNs, though, are preferred by most issuers and investors, not least because they have unique Cusips and can be cleared and settled at the DTCC and distributed more widely.

“As a funded security, a CLN can be levered and financed by the investors, for example under a repo” says Jed Miller, a partner in the structured finance team at Cadwalader. “It is also an instrument that’s more liquid than a bilateral credit default swap.”

Regional differences

While G-Sibs sit on the sidelines, US regional banks have obtained significant capital relief via CLN transactions. Capital savings are rarely disclosed, although PacWest **reported** a 20 basis point improvement in its capital ratio after issuing a $132.8 million deal in October 2022 that referenced a $2.66 billion pool of single-family residential mortgages. Western Alliance has closed at least four CLN transactions since 2021, **according to rating agency Moody’s**. In March 2022, Merchants Bank of Indiana, which had just $14.2 billion in total assets at the end of 2022, sold $158 million of CLNs **referencing** a $1.1 billion pool of loans to nursing and retirements. That deal followed the securitisation of $1.2 billion of multi-family bridge loans in September 2022.

The regional banks declined to comment on their deals.

The transactions have raised eyebrows in banking circles, in part because of the high coupons paid to investors, which can only be justified by significant capital savings.

The five-year notes issued by Merchants Bank in March accrue interest at a rate equal to the secured overnight financing rate (SOFR) plus 15.50% – meaning investors could see returns in excess of 100% over the lifetime of

the deal, if losses on the underlying loans do not exceed the trigger point of 1%.

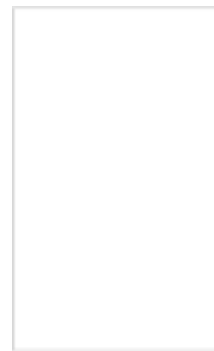

Photo: Nyttend/Wikimedia

Merchants Bank of Indiana

“The transaction will result in a reduction in the bank’s risk-weighted assets and will benefit the bank’s regulatory capital ratios,” Merchants said in a regulatory filing.

PacWest’s $133 million deal issued last September pays SOFR plus 11% over 30 years.

The CLNs issued by Texas Capital and Western Alliance were less costly, with coupons ranging from 3.5% to 8.5% over SOFR or Libor.

The CRTs executed by G-Sibs tend to generate more modest capital savings and are priced commensurately. “The difference from our vantage point is the deals from the likes of JP Morgan are insignificant relative to their overall balance sheet and have a de minimis effect on their capital ratios, whereas for PacWest or Western Alliance, the implication or the effect is more pronounced,” says Christopher Wolfe, head of North American banks at Fitch Ratings. “If JP Morgan does one of these deals and moves its capital ratio up one basis point, it doesn’t matter very much. But if you are raising your capital ratio by, say, 60 basis points, that’s really starting to move the needle.”

For larger banks, the objective is often to reduce risk, not just capital requirements. “The G-Sib deals tend to be less about regulatory capital requirements and more about managing risk appetite and concentration limits internally,” says the industry source.

CRT revival

Banks of all stripes will be paying more attention to their credit RWAs

when the US version of the final Basel III rules are published. Public comments made by regulators indicate higher capital requirements could be on the cards for banks with assets above $100 billion, including G-Sibs.

On June 22, FDIC chair Martin Gruenberg gave the strongest indication yet that regulators are planning to **scrap** the internal ratings-based (IRB) approach for credit risk, leaving banks to calculate their capital requirements using only the standardised approaches.

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Gareth Old, Clifford Chance

Standardised RWAs for credit risk tend to be higher than IRB outputs and are much less granular, so they may not reflect the bank's own internal view of the **economic risk** of its credit exposures. Making it easier for banks to manage those higher RWAs downwards using CRTs would be a welcome **trade-off** for banks, in keeping with Barr's promise of a holistic approach to Basel III.

"To the extent the Basel III endgame proposals result in higher regulatory risk-based capital that the banks have to hold, what we're hearing from a lot of our bank clients is that this will lead to increased interest in capital relief trades, as a way for banks to manage and optimise their risk-based regulatory capital," says Cadwalader's Miller.

G-Sibs are hoping the final Basel III reforms or an associated rulemaking will tweak the wording of Reg Q to recognise a wider range of CRT transactions that have the same economic effects as CDSs or financial guarantees on bank credit portfolios.

Old at Clifford Chance says any clarification contained in the proposal

could herald an immediate revival of the CLN pipeline, especially given that "there's so much focus on capital and capital efficiency now".

"For a long time, the market was worried that the Fed for some reason was just down on using the synthetic securitisation architecture, so I think the immediate benefit of whatever is in the rule is that it is going to give us an indication of the extent to which the Fed is going to support banks engaging in CRT transactions," says Old. "Banks are really trying to use every avenue, every investor base, and every tool that is available to them, and regulators are focusing on making sure that can be done in a prudent, safe, sound, but nonetheless executable way."

Additional reporting by Menghan Xiao

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