Capital Relief Trades[1]

By Courtney Smith and Brandon Spleen

The "Capital Relief Trades" panel covered questions relating to credit risk transfers ("***CRTs***") and their increasing relevance in United States finance markets.

The panel discussed the following questions:

- **Why are U.S. banks dealing with capital constraints, and why is the risk transfer market becoming a more viable solution to deal with this issue?** U.S. banks are facing capital constraints due to increasing interest rates, which result in decreased prices for legacy assets and Accumulated Other Comprehensive Income ("***AOCI***") losses. Banks are simultaneously grappling with the "Basel III Endgame", various changes in the standard approach and advanced approach for different tier banks, and the current recession. In this environment, the risk transfer market has become a viable option for U.S. banks to deal with capital constraints, thanks in part to U.S. regulators providing clarity on how banks can utilize CRTs, synthetic risk transfers ("***SRTs***") and inverse transfers to help alleviate capital constraints. These tools will allow banks to free up some of their debt capital, which may be held back by legacy assets.

- **How can banks achieve capital relief through CRTs, and what are the key regulatory requirements?** Under Regulation Q of the Board of Governors of the Federal Reserve System ("***Reg. Q***"), a bank can use synthetic securitization to tranche a portfolio, then sell the tranches of exposure to investors, which would allow the bank to reduce its capital charges by up to 80%. Under Reg. Q, a bank is not required to engage in a significant risk transfer; it only has to transfer the credit risk of an asset pool, with at least two tranches in the structure (a senior tranche held by the bank and junior tranche(s) sold to investors).

- **Why are CRTs an attractive alternative to other capital optimization strategies such as issuing equity or selling assets?** Banks typically prefer to maintain the customer relationships and fee income associated with a credit facility, and they do not want to sell legacy assets at a loss. Issuing equity comes with other problems from the bank's perspective, including high execution costs, dilution, and negative market perception. CRTs are an efficient way to optimize capital; in addition to avoiding the pitfalls associated with an equity issuance or asset sale, CRTs allow the bank to reduce the risk weighting for a pool of loans to around 20%, while the bank continues to hold and service the assets. CRTs do, however, have a few drawbacks: they require complex documentation that, in many cases, needs to be finalized

[1] The panelists were Kevin Alexander, Partner in the Ares Credit Group; Missy Dolski, Senior Managing Director and Global Head of Capital Markets at Värde Partners; David Lucking, Partner and Head of Global International Capital Markets at Allen & Overy LLP; Angela Ulum, Partner and Co-Leader of Banking and Finance Practice at Mayer Brown LLP; and Bo Weatherly, Managing Director and Head of Structured Credit Group at U.S. Bank. The panel was moderated by Derek Li, Managing Director of the Alternative Markets Group at Goldman Sachs.

and executed in a short amount of time; they require large investor commitments (often funded in cash at closing); and they require investors to evaluate a large bank portfolio for expected losses and returns.

- **What are the potential pitfalls of using CRTs in connection with a subscription line portfolio, and how can they be addressed?** Borrower confidentiality (including borrower identity and the particular terms of a loan) is one of the primary concerns that borrowers have with CRTs. Data rooms with anonymized data are a common tool to put borrowers at ease. Investors focus on concrete eligibility criteria for the assets that can go into the portfolio. Terms are narrowly defined in a way that gives investors the ability to conduct their credit assessment, even if they do not have access to the identity of the borrower. Since most subscription facilities are revolving credit facilities, and the principal note amount in a typical CRT is static, CRTs are structured to incorporate a replenishment feature which relies on the eligibility criteria in terms of what the issuer can put into the portfolio, even after the notes have been issued.

- **What types of investors are active in this market?** The type of investor will depend largely on the structure and asset class, along with the capital stack location. Private equity, hedge fund managers, asset managers, mutual funds, insurance companies pension funds and endowments are often direct investors.

- **What are the most common structures that banks are doing?** The most common structures for U.S. banks are indirect credit-linked notes ("***CLNs***") or direct CLNs. While direct CLNs have been issued by non-U.S. banks for a while, U.S. regulators have not issued blanket approvals for the issuance of direct CLNs. Accordingly, banks are required to seek affirmative approval from regulators for direct CLNs. Four banks have received specific approvals from U.S. regulators to use this direct structure for a fixed number of assets, but other issuances would require additional approvals. If a bank cannot issue a direct CLN or the investor prefers a different structure, banks will follow a more common structure that was recently confirmed by U.S. regulators which is to create a special purpose vehicle ("***SPV***") to issue notes to the investor, with the proceeds of the notes collateralizing the transaction.

- **What guidance have U.S. regulators provided with respect to CRT structures?** In September of 2023, U.S. regulators clarified that the SPV CLN structure would be treated as a synthetic securitization for Reg. Q purposes. However, there are still other regulatory structures and policies that banks will need to be concerned with, including Dodd Frank and Volcker. More particularly, banks seeking a direct CLN need to obtain regulatory approval for a specific structure. If the bank significantly deviates from this structure, it will need to go back and get further approval. Furthermore, for direct CLNs, regulators have indicated that they can impose certain limitations on the amount of issuance that the bank can do.

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