

## KEY POINTS

- US community and regional banks are under pressure to maintain strong capital positions and continue to lend in the Main Street economy.
- A credit risk transfer (CRT) trade keeps the entire loan pool on the bank's balance sheet by synthetically transferring risk to a third party.
- When structured correctly, CRTs can help better manage risk, mitigate credit concentrations, and reduce regulatory capital charges.
- Unlike a portfolio sale, CRTs offer an opportunity for investors to acquire concentrated credit exposure without the burden of servicing or default management.

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# A path back to growth for community banks: credit risk transfer trades

Many community and regional banks in the US are under intense pressure from economic forces that are outside of their control. These locally oriented banks are increasingly turning to credit risk transfer (CRT) trades as a way to reopen the lending pipeline. CRTs keep existing loans on a bank's balance sheet, while de-risking the portfolio and providing substantial capital relief to fund new lending. Further, by shifting risk to non-bank investors, CRTs provide a new channel for private equity and others to deploy the funds that they have accumulated over the last several years.

Community and regional banks make up the vast majority of banks in the US. These institutions historically have provided vital credit to their service areas, which is commonly referred to as Main Street lending.

In recent years, however, community and regional banks have been buffeted by a never-ending series of challenges. These institutions increasingly are looking for ways to manage their existing loan portfolios that allow them to continue to lend. One of the most promising techniques being used by some banks is the credit risk transfer (CRT) trade. CRT is a form of synthetic securitisation that can be done by almost any pairing of bank and investor. This article explains how CRTs function and why they may be of interest to community and regional banks.

## BACKGROUND

Banks intermediate the financial system by borrowing money from depositors, lending that money to debtors, and earning interest on the differential. Under current economic conditions, community and regional banks face several challenges to performing this vital function, which include:

- Many community and regional banks are small institutions, and they may have difficulty raising funds through traditional capital market mechanisms (eg common stock issuance, public debt offering).

- Historically, community and regional banks have lent within defined service areas, a practice that results in geographic and other credit concentrations.
- Banks typically are expected to carefully manage their credit exposure, on both an overall basis and to specific concentrations, which may mean they cannot make new loans based on the characteristics of their existing loan portfolios.
- Community and regional banks often differentiate themselves from money center banks by maintaining a relationship with their customers, which can be impaired if a customer's loan is sold to a third party.
- Potential third-party investors in bank loans may not be interested in actually acquiring the loans, having servicing rights, or having direct exposure to default servicing of loans.

## REGULATORY CAPITAL REQUIREMENTS

Under US regulatory capital requirements, banks are required to maintain certain minimum capital to risk-weighted asset ratios (the "risk-based capital ratios") and a capital to total assets ratio (the "leverage ratio").<sup>1</sup> These requirements were significantly increased after the 2008 financial crisis, and, today, banks of all sizes are expected to maintain robust capital ratios. The amount of capital a bank must maintain with respect to any particular loan is typically a significant – if not *the* most significant

– factor in determining whether the lending relationship is profitable or even feasible.

A community or regional bank calculates the amount of its risk-weighted assets by multiplying the amount of its exposure to each asset by the risk weight associated with that type of asset or exposure.<sup>2</sup> Risk weights are defined in the regulatory capital requirements and reflect the regulators' assessment of the comparative risk of different types of assets and exposures. In general, the more liquid and less volatile an asset (or exposure) is, the lower its risk weight will be, meaning that a bank will be required to hold less capital with respect to that asset. For example, the risk weight for US Treasuries is 0%, while the risk weight for high-volatility commercial real estate exposures is 150%.<sup>3</sup>

Banks may be able to reduce the amount of regulatory capital required for on- and off-balance sheet exposures by converting exposures from corporate or consumer exposures to securitisation exposures. This is due to the fact that the risk weight under US regulatory capital requirements for typical senior securitisation exposures can be as low as 20%, while the risk weight for most other lending exposures is 50 or 100%.<sup>4</sup> That means a senior securitisation exposure can have required capital of one-fifth the amount required for holding a position in the original loan. In this regard, not all securitisation structures and underlying assets are treated equally, at least not under US regulatory capital requirements.

## SYNTHETIC SECURITISATION

To address the challenges discussed above, a bank may seek to transform an existing exposure into a securitisation exposure, which has a lower risk weight. This can be done by creating a synthetic securitisation, which synthetically transfers a portion of the bank's credit risk to a third party. There are several

# Feature

## Biog box

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steps to synthetically securitising an exposure through a CRT. Below we provide a high-level summary of these steps.

### 1. Synthetic securitisation definition:

A CRT is defined as a transaction in which:

- a. all or a portion of the credit risk of one or more underlying exposures is retained or transferred to one or more third parties through the use of one or more credit derivatives or guarantees (other than guarantees that transfer only the credit risk of individual retail exposures);
  - b. the credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority;
  - c. performance of the securitisation exposures depends on the performance of the underlying exposures; and
  - d. all or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities).<sup>5</sup>
2. **Operational requirements:** Credit risk mitigants are techniques that a bank may use to mitigate credit risks associated with an existing exposure (eg a bank may buy a credit derivative to offset an exposure's credit risk). A bank may recognise the use of a credit risk mitigant in a CRT to hedge underlying exposures only if certain operational requirements are satisfied.<sup>6</sup> These generally include credit risk mitigants that are financial collateral, an eligible guarantee, or an eligible credit derivative.
3. **Due diligence requirements:** A bank must demonstrate a comprehensive understanding of the features of a CRT exposure that would materially affect the performance of the exposure to avoid triggering a punitive 1,250% risk weight.<sup>7</sup> This must be demonstrated at the time an exposure is originated/acquired and on an ongoing basis.
4. **Risk weighting senior securitisation exposure:** The bank will calculate its risk weight for the senior tranche of a CRT using the simplified supervisory formula approach or gross-up approach. This may result in a risk weight as low as 20%.

### 5. Risk weighting subordinate

**securitisation exposure:** Because a CRT does not remove the underlying assets from the balance sheet of the transferring bank, the bank will look to the rules regarding credit risk mitigation to determine the risk weight of the exposure it holds in relation to the transferred tranche of credit risk. This may result in a 0% risk weight if the exposure is secured by financial collateral (ie cash on deposit, including cash held by a third-party custodian or trustee), or it can be a risk weight corresponding to the risk weight for the counterparty providing the guarantee or credit derivative if that counterparty is an eligible guarantor.

## CRTs BY COMMUNITY AND REGIONAL BANKS

The first CRT by a regional bank post-implementation of the Basel III reforms was done by Texas Capital Bank in 2021, and it related to its mortgage warehouse lending program. In its press release, Texas Capital noted that the CRT provided the bank with enhanced credit protection on its warehouse lending portfolio and would significantly improve its regulatory capital ratios.<sup>8</sup> This would allow the bank to continue to provide mortgage warehouse lending "through all market environments".

Several CRTs have been executed by regional and community banks since the Texas Capital trade. One of the most recent and notable was the CRT executed by Merchants Bank of Indiana. Merchants is a community bank with about \$10bn in total assets. In March 2023, Merchants executed a \$158m CRT with respect to its portfolio of over \$1.1bn of first-lien floating rate skilled nursing and senior housing bridge loans. It indicated that the CRT would reduce the bank's risk-weighted assets under the capital requirements and would allow the bank to continue lending to the health care and senior housing real estate markets.<sup>9</sup>

CRTs by community and regional banks have tended to be by banks with more than \$10bn in total assets and with respect to loan portfolios of at least \$1bn. This may reflect the mitigating effects of the community bank leverage ratio option for electing banks under the \$10bn threshold.<sup>10</sup> Additionally, CRTs do not reduce balance sheet assets, which

make them unattractive from the perspective of managing regulatory requirements that are tied to total assets (eg the fee limitations of the Durbin Amendment). However, the lack of CRTs by smaller community banks also might reflect the fact that capital levels and concentration risk were less prominent concerns during the Federal Reserve's accommodative monetary policy period.

Further, it may be possible for groups of community banks to collaborate on a CRT. Doing so would have the advantage of lowering transaction costs for individual banks and potentially diversifying the risk profile of the CRT for investors. This is because it would allow small banks to transfer the credit risk of their loan portfolios while not bearing the entire burden of doing a private debt deal. The key to a CRT is a pool of homogenous assets, and one beneficial attribute of community banks is that their asset composition tends to be uniform across institutions.

## CONCLUSION

Community and regional banks in the US have long faced the pressure of being too small to succeed when compared to super-regional and internationally active banks. This pressure has only increased in the ongoing high-interest rate environment. But these locally oriented banks may turn to CRTs as a way to de-risk their balance sheets, reopen the lending pipeline, and improve capital positions. Further, by shifting risk to non-bank investors, CRTs can provide a new channel for private equity and others to deploy the funds that they have accumulated over the last several years. ■

- 1 12 C.F.R. §§ 3.10(a), 217.10(a), 324.10(a). CRT generally does not provide relief from the leverage ratio requirement.
- 2 12 C.F.R. §§ 3.31(a), 217.31(a), 324.31(a).
- 3 See 12 C.F.R. §§ 3.32, 217.32, 324.32.
- 4 See 12 C.F.R. §§ 3.43(f), 217.43(f), 324.43(f).
- 5 12 C.F.R. §§ 3.2, 217.2, 324.2.
- 6 12 C.F.R. §§ 3.41(b), 217.41(b), 324.41(b).
- 7 12 C.F.R. §§ 3.41(c), 217.41(c), 324.41(c).
- 8 Press Release, TCBI announces steps to enhance the company's balance sheet (9 March 2021).
- 9 Press Release, Merchants Capital Completes Securitization of \$1.1BB+ in Healthcare Real Estate Loans (10 May 2023).
- 10 See 12 C.F.R. § 3.12, 217.12, 324.12.