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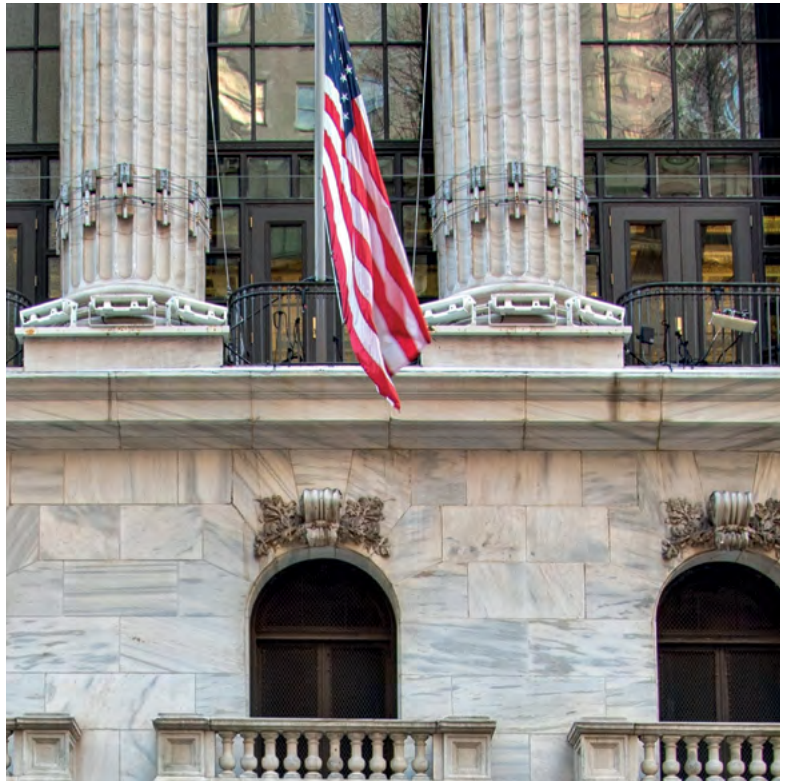


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London, October 2024

The SRT market has and is attracting considerable attention, with unprecedented growth worldwide. Growth is in fact, a clear common thread in SCI's inaugural SRT Journal publication. Naturally, with increased exposure and approval often comes criticism and scepticism. Evidently, this collection of essays and research confront the – often publicly voiced – lack of understanding of the inherent complexities of the asset class.

This year's chapters focus and elaborate, for the large part, on the catalyst seen through the significant (re)entry of US banks in this market. In this context, themes include supply and demand dynamics, regional banks and the standardisation of market terms. We additionally investigate developments in the unfunded mortgage SRT market and question whether Latin America is the sector's most promising emerging market.

Along with consistent growth and heightened focus, experts and investors widely agree that the asset class can offer diversification, income, and exposure to banks' more tightly-held assets, thus generating attractive, risk-adjusted returns.

While I do not possess the often expressed platitude and metaphor of a crystal ball, it is hard to imagine similar themes or enthusiasm not being repeated in the near future.

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CHAPTER ONE: GROWING PAINS?

The momentum seen this year in US CRT has created what some view as a banks' market. **Corinne Smith** investigates whether recent developments, in fact, represent a natural progression of the sector.

The US Fed's FAQ on CLNs in September 2023 sparked anticipation that the floodgates would finally open for US bank CRT issuance, resulting in many new investors exploring the sector and an initial wave of transactions. The momentum subsequently seen this year in US CRT has altered supply and demand dynamics, with some describing it as a banks' market, due to the deluge of new investment coming into the sector. Others, meanwhile, view these developments as a natural progression of the market.

Private credit funds last year raised an estimated US\$200bn-US\$300bn and are motivated to deploy that capital before the investment period ends, including in strategies with an CRT element (see Figure 1). However, the supply side of the equation hasn't changed much.

The initial wave of issuance following the Fed's FAQ reflected a clearing of pent-up supply from the previous period of regulatory uncertainty, according to a recent Seer Capital Management research report. The deals primarily consisted of thick tranches referencing investment grade corporate loans and thin

tranches referencing auto loans, which were placed with large investors at spreads in the mid-single digits. Notably, JPMorgan sought to complete a vast amount of issuance rapidly, therefore only engaged with large investors with ticket sizes of several hundred million.

"Although a few US banks have priced very large deals, there has yet to be a meaningful increase in the number of transactions being brought to the market. More investors competing for the same amount of trades has therefore driven spreads tighter," explains one source.

Spread tightening

SCI's SRTx Spread Indexes show that between December 2023 and July 2024, contributors' pricing opinions fell from 1,278bp, 1,173bp, 1,173bp and 969bp to 1,033bp, 1,000bp, 919bp and 625bp across the US SME, European SME, European corporate and US corporate SRT segments respectively (see Figure 2).

At the same time, now that a number of US banks have become repeat issuers and are comfortable with the regulatory guardrails, execution of certain types of US CRT transactions is becoming more of a pricing matter, rather than a structuring matter – which Eri Budo Uerkwitz, counsel at Mayer Brown, describes as a "natural progression of the market". But one issue with moving towards pricing-based execution is that not everyone that is bidding may fully understand the product.

"Given there have been so few losses and credit events in the US CRT market, it is questionable whether all investors that seek an allocation nowadays know how to underwrite a portfolio. It wouldn't be the first time that some investors in an overflow buyers' market do not do, or are not capable of doing, the necessary diligence and end up driving pricing down," Uerkwitz observes.

She adds: "And pricing may also be driven down by more sophisticated investors that have raised dedicated CRT funds and now sit on funds they need to deploy. So, it's unclear whether some funds are investing in CRT because they need to execute or because it's their investment thesis."

The concern is that if deal terms are being driven by less sophisticated investors seeking allocations, the pricing may not be commensurate with the true risk being transferred. "Whether the risk is inappropriately priced is debatable. If a deal is executed, ultimately it means that the protection buyer and the protection seller must agree on the price," the source suggests.

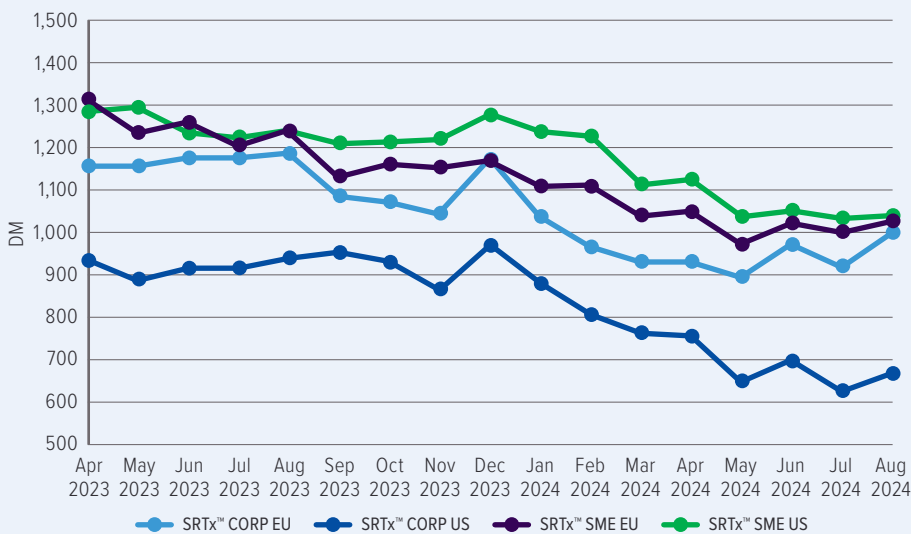
Matthew Moniot, co-head of credit risk sharing at Man Group, doesn't believe that new investors are pushing prices to unsustainable

“ALTHOUGH A FEW US BANKS HAVE PRICED VERY LARGE DEALS, THERE HAS YET TO BE A MEANINGFUL INCREASE IN THE NUMBER OF TRANSACTIONS BEING BROUGHT TO THE MARKET”

Figure 1: Private credit growth



Figure 2: SRTx™ spread indexes



Source: SCI SRTx™

levels. However, he says it's evident that much of the margin for error has disappeared.

"Assuming CRT pricing has not impacted the quality of loan underwriting, the reduction in spreads will likely lead to a reduction in market returns. Some participants may utilise leverage to get back to higher returns, but that will only increase their sensitivity to credit risk," Moniot observes.

Seer, for one, did not find the initial wave of US deals attractive relative to European SRT issuance. "Given mid-single digits pricing and high minimum ticket sizes for deals backed by large corporate loans and capital call facilities, and dramatic spread tightening of the thin junior tranches of auto loan CLNs, Seer has found US reg cap deals less compelling than reg cap from other jurisdictions thus far," the firm notes in the research report.

The Seer research cites US auto CLNs as an example, in which issuers typically retain a small first loss (bottom 1%-3%) and issue many thin mezzanine tranches (0.5%-2.25% thickness) up to a 12.5% attachment. At the same time, the dramatic spread tightening in US auto

CLNs has seen second loss spreads dropping more than 1100bp and third loss spreads dropping more than 400bp (see Figure 3).

"With such thin tranches, if losses exceed expectations, investors in the second and even third loss tranches risk losing a significant portion of their investment," Seer warns.

The firm notes that on the back of the hype around the US market, there has been greater demand for some European transactions in recent months, but spreads overall have remained in line with the past several years. "European issuers who have established issuance programmes over the past 10-plus years continue to transact with a limited number of longstanding partners, rather than with new players who express eagerness to join the market but are unlikely to be long-term participants. We believe that in time, many US banks

of all sizes will take advantage of reg cap. As the market develops and supply increases, spreads in US reg cap should widen back to appropriate levels."

Market bifurcation

In the meantime, banks appear to be capitalising on the current demand dynamic. Sagi Tamir, partner at Mayer Brown, suggests that in this environment, two markets for US CRT transactions could emerge – a 'straightforward' one and a bilateral, bespoke one. The former will involve the more syndicated transactions, while the latter will evolve as it solves for unique situations, such as new asset classes, riskier portfolios of proven asset classes and unique confidentiality or proprietary challenges.

Indeed, Moniot suggests that a bifurcation is already emerging. "There is a clear distinction between the more straightforward trades, which attract non-specialist investors, and the bespoke trades that involve a genuine partnership between investor and issuer. As such, investors who leverage structuring knowledge and creativity will differentiate themselves from those who simply buy fully baked deals."

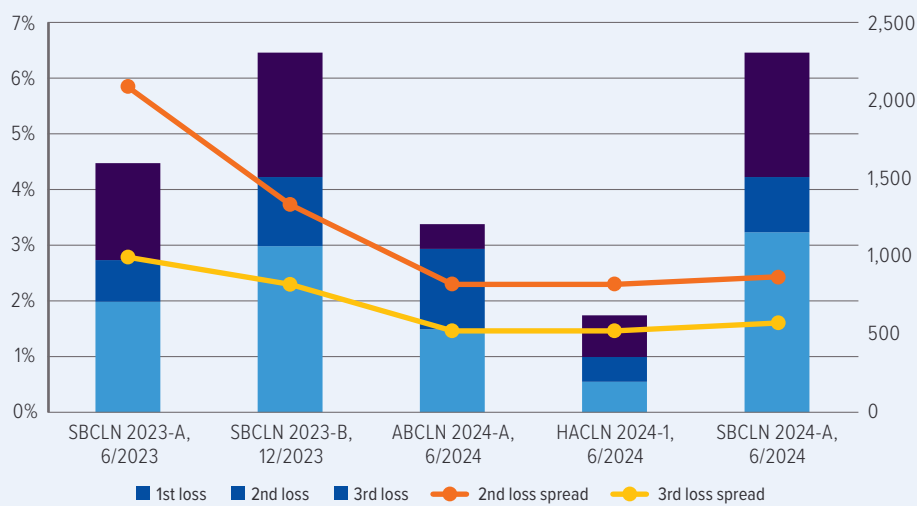
Uerkwitz agrees that in the current environment, investors are more likely to thrive if they can overcome these differences by being creative, thoughtful and open to figuring out solutions together with an issuer. "A 'helpful' investor will look through to the substance of the economics of a transaction and recognise that the economics can be the same, even if the terms of the structure are different to what they are used to," she explains.

She indicates that investors can still compete on deals that are bespoke in structure and/or reference non-standard asset classes. "Investors can maintain their market share by looking for assets that are difficult for banks to syndicate. In these scenarios, investor-issuer partnerships have real value."



Matthew Moniot, Man Group

Figure 3: Junior tranche thickness and spreads of recent US Auto CLNs



Source: Seer Capital Management

“INVESTORS CAN MAINTAIN THEIR MARKET SHARE BY LOOKING FOR ASSETS THAT ARE DIFFICULT FOR BANKS TO SYNDICATE. IN THESE SCENARIOS, INVESTOR-ISSUER PARTNERSHIPS HAVE REAL VALUE”

Although the US Fed’s guidance regarding Regulation Q in September 2023 provided clarity in connection with direct CLN issuances, it also placed a limit of the lower of 100% of capital and US\$20bn on the principal amount of assets with respect to which a banking organisation may transfer risk via direct CLNs (*SCI 29 September 2023*). Since the G-SIBs are likely to blow through the US\$20bn limit very quickly, it begs the question of which books banks are willing to subject to the direct CLN route.

Perhaps more saliently, indirect CLN structures that do not consolidate to the banks are consequently becoming appealing to banks that need to manage this US\$20bn cap, according to Tamir. He adds that a growing number of investors are taking on responsibility for the SPV – an arrangement that is viewed as a win-win for those investors and related banks. For investors who can do this, it provides a way to win a significant allocation (up to 100%); for the related bank, it provides a route for an issuing vehicle that isn’t consolidated onto the bank’s balance sheet and, therefore, does not count towards the US\$20bn cap.

“However, not every investor has the capability to do this. We are seeing some more sophisticated investors ‘market’ this ability as a way of differentiating themselves. Ultimately, banks are more likely to bid deals out to investors who can actually provide a service,” he notes.

Relative value

The CRT market has previously witnessed periods when new investors enter, attracted by the relative value on offer, which then exit when other opportunities arise. “We have seen cycles in which pricing tightens before, but eventually supply and demand dynamics balance out. This time around, however, I expect more of the new investors to stay,” the source observes.

The source suggests that one reason is because there is more visibility in terms of the



Mehdi Benleulmi, RenaissanceRE

supply side, compared to before, which is – in turn – due to there being more regulatory visibility. Another reason is that funds aren’t in the business of changing their strategy every year.

“The new entrants will have spent a lot of time and resources raising dedicated capital and explaining their CRT strategy. Consequently, they are likely to have a more consistent approach to the market today,” the source indicates.

Meanwhile, given the heightened interest in CRT from funded protection sellers, some new originators currently appear to be dedicating fewer resources to unfunded issuance. However, this may also be a function of the need to further develop and demonstrate the value of the unfunded side of the market more generally, since the number of (re)insurance players with CRT expertise remains limited.

According to Mehdi Benleulmi, head of credit – Europe at RenaissanceRE: “As a (re)insurance company, we view CRT as a partnership with our banking clients. We seek to renew our trades with the same counterparties – which makes a difference in terms of pricing, as we can approach it on a through-

US FUTURE

The European SRT market has taken years to reach its current robust state and the US market is similarly expected to take time to fully develop. In the meantime, Seer Capital Management anticipates that many of the new investors exploring the US market will become frustrated and return to their previous focus areas.

Key factors that will contribute to the growth of the US market in size and diversity in the near to medium term, according to Seer, include:

- Clarification of the regulatory environment
- Establishment of consensus around the optimal structure; likely SPVs that can be used for all types of assets and syndicated to a variety of investors
- Large banks that have completed initial deals referencing on-the-run assets, such as IG corporate loans, looking to other areas of their balance sheet to optimise capital allocation
- Smaller banks devoting the time and marshalling the resources needed to complete a first-time transaction.

“As more and more banks join the market, reg cap will become a standard tool which investors/equity analysts expect US banks to employ, as they do in Europe,” the firm concludes.

the-cycle basis, rather than at a given point in time. As experts in bringing efficient capital to our clients, we’re here to stay, which minimises long-term balance sheet management risk for our counterparties.”

Benleulmi, for one, hasn’t noticed any changes in the level of transparency and disclosures provided by banks in connection with CRT transactions. He suggests that while it is arguably currently a bank-oriented market, this environment could always change.

“Will the new counterparties still be there for issuers when the market turns? We expect that banks will continue to execute bilateral trades alongside widely syndicated deals. Banks utilise CRT as a tool to manage their balance sheets and therefore need to ensure that they can continue to do so in various market environments,” Benleulmi concludes. ▶





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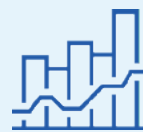
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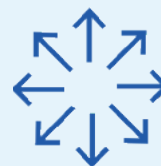
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CHAPTER TWO: MOVING PARTS

Regional banks in the US are slowly embracing CRT but many are still pondering their favoured path. **Kenny Wastell** explores this expanding segment of the market.

CRTs are becoming increasingly attractive to US regional banks, having historically remained almost exclusively the preserve of so-called global systemically important banks (G-SIBs) in the country. Yet a much anticipated wave of issuance in 2024 has not fully materialised, with players entering the market more gradually and deliberately as they negotiate various challenges.

The growing interest had been partly attributed in some quarters to Basel 3 Endgame and the touted lowering to US\$100bn of the total assets threshold over which the sternest capital adequacy measures were expected to apply to US banks. In September, this incentive was diminished when Federal Reserve vice chair of supervision Michael Barr announced banks with between US\$100bn and US\$250bn would no longer be subject to some of those measures. Yet, as SCI reported at the time, sources close to the market believe the relaxations will not bring regionals' use of CRT to a halt, with only around 20 institutions falling within that bracket.

Another – arguably key – catalyst for issuance has been the Fed FAQ of September 2023, which included Regulation Q clarifications over the recognition of directly issued CLNs under the capital rule. Under the FAQ, a Fed-regulated institution can recognise the credit risk mitigation of the collateral on a reference portfolio within the rules for synthetic securitisations, provided that the operational and due diligence requirements are met and



Matthew Bisanz, Mayer Brown

that the transaction satisfies the definition of 'synthetic securitisation'.

The direct CLN route potentially offers a more straightforward pathway to CRT for banks compared with structures requiring execution of a credit default swap or financial guarantee with a counterparty – often an SPV, which will then issue CLNs. This clarification has proven, at least to some extent, to be a driver of activity. Issuance by regional banks has since grown, with Huntington, Merchants and Ally among those receiving approval for direct CLNs to be treated as synthetic securitisations.

Yet many investors will likely look at the bank risk associated with direct CLNs – which is more pronounced with smaller regional banks compared with G-SIBs – and conclude that it is not for them.

In July this year, Pinnacle Financial Partners and Valley National Bank entered the market with transactions – notably both SPV CLN or CDS-based, rather than direct CLN-based deals – referencing mortgage and auto loan assets respectively (*SCI 29 July and 29 July*). Both banks have below US\$100bn in assets, meaning they would have fallen below even the formerly anticipated threshold for Basel 3.

Matthew Bisanz, a partner in Mayer Brown's regulatory practice, says regional banks have the same need for capital enhancement as larger banks – if not greater. However, many are still negotiating the various barriers to entry into what is a complex arena. Bisanz explains that regionals have a lower level of familiarity with the product. Typically, those that have used CRT have done so because they hired or were advised by somebody who happens to have the relevant expertise. While they have needed capital relief, he says, it has almost been by "happstance" that they stumbled into CRT.

"For many of these regional banks, it is difficult to access capital markets in other ways," says Bisanz. "The two other main options are selling equity and selling assets. If you are a small regional bank in Illinois, for example, there isn't a high demand for your equity – you're not going to get a premium on it and it will be dilutive to existing shareholders. If you sell assets, you will take a lot of losses because of the change in interest rate and potentially lose control of part of the customer relationship. Your two go-to strategies right now probably aren't going to work." This makes CRT very appealing.

The relative lack of CRT activity in the US – compared with the European market – is partly due to a lack of historical need. Indeed the development and growth of synthetic securitisations in Europe was largely driven by banks' requirement to recapitalise in the aftermath of the global financial crash. US banks, as a whole, did not face the same scale of task in having to develop such instruments to build up capital.

It is also partly due to a lack of awareness of the product, says Angela Ulum, partner and co-leader of the banking and finance practice at Mayer Brown. US players with a financial markets focus have been conscious of activity in the space, she says. However, awareness among regional banks only started growing recently, accelerated by coverage of the topic creeping into mainstream financial news outlets.

"To somebody with a structured finance background, CRT is one option for banking seeking capital optimisation," says Ulum. "Many investors are agnostic as to whether they acquire exposure to a portion of assets through a credit risk transfer, a portfolio sale or an off-balance-sheet securitisation, all of which can have the effect of reducing a bank's required capital. Looking at these as various tools, some of the benefits of CRT aren't present with portfolio sales, off-balance-sheet securitisations or by reducing origination flow. So we're likely to see CRT used more strategically."

Barriers to entry

Nonetheless, Ulum says the wider industry had expected to see significantly more CRT issuance from regional banks in 2024 than there has been to date. In part, she attributes this to challenges banks face in putting together portfolios that could both benefit from capital relief and offer an attractive risk profile for investors. Portfolios of commercial real estate, for instance, would prove challenging.

Additionally, selecting among direct CLNs and eligible CDS structures – which may or may not include the issuance of SPV CLNs – can prove intimidating, as can navigating any resultant regulatory questions and operational challenges. Questions remain as to whether banks have the required historical loss and delinquency information and whether they are able to track losses and recoveries as required in CRTs. Reporting systems as a whole may require significant investment. There are challenges for banks to produce the loan-level information required and to evaluate and confirm eligibility criteria for reference assets that matter to investors.

"As banks are considering different asset classes and different portfolios, or even getting into the market, it's important they are on board

with investing in the operational challenges to be able to do that,” says Ulum. “There are a number of different companies trying to provide solutions, but that has been one of the more intimidating factors as banks think about getting into this market or expanding into different asset classes – even when they are already out with one asset class.”

There is a temptation among some banks, Bisanz says, to attempt to avoid some of the costs of entering the market – specifically the six-figure sums associated with hiring experienced financial advisors to help structure economic terms. Avoiding such hires is a course he cautions against.

“If you haven’t done one of these before, it’s often prudent to hire a knowledgeable financial advisor or broker,” says Bisanz. “Put aside the fact that you won’t negotiate as good a deal versus a more sophisticated counterparty. How are you going to get the data from your loan portfolio or even pick your loan portfolio [without those expertise]?” Many who look to cut corners may find themselves falling behind their peers, Bisanz fears, in a bid to avoid making a hire that would cost “a few hundred thousand dollars”.

The challenges of transitioning into the CRT market, more often than not, also involve selling the vision and potential benefits within banks themselves – not least to senior management, who themselves may be naturally resistant to a new unfamiliar financial product. A lot of time and energy is required, Ulum explains, in the organising of different stakeholders within the institution to come on board.

“Typically, the people who are worried about capital or cost of equity may be in one department, treasury is in a different department, and the line of business that actually touches the assets is in a third,” Ulum says. “Somebody has to have the vision and the force of personality to get those different groups together to understand the value proposition for CRT – and be able to invest the upfront cost in building the systems and understanding the structure. Once you do the first deal, there are many economies of replicating a transaction multiple times.”

It follows that, for those banks that do reach a consensus in favour of CRT, the benefits could become incrementally more significant over time. Ulum argues that, as more programmatic issuers start providing proof of concept and are able to determine the terms they care about and those they do not, pricing should start to tighten.

Identifying candidates

Once a consensus is reached – or as part of that process – the task is identifying portfolios that are best suited to CRTs. Bisanz highlights that there are a small number of regional US banks with auto loan portfolios that justify a CRT such as that executed by Valley National. That deal, he points out, was issued on US\$1.5bn of loans, a strikingly high percentage of the bank’s



Angela Ulum, Mayer Brown

US\$1.8bn total auto loans portfolio. There may be some other regionals in a position – and of an inclination – to follow this lead, according to Bisanz, but not many.

“There are a small handful of regional banks with a significant non-bank lender, fund finance or specialty finance business,” says Bisanz. “That’s a very desirable portfolio. Commercial real estate can also be attractive, but it has to be the right kind. If you have a lot of rent controlled apartments or urban rental office space, for example, that isn’t good. But unregulated multifamily or seasoned owner-occupied are more interesting. A lot of people look at doing resi mortgages, which is a good CRT candidate, although it is less capital efficient because of how US capital rules work.”

“THERE ARE A SMALL HANDFUL OF REGIONAL BANKS WITH A SIGNIFICANT NON-BANK LENDER, FUND FINANCE OR SPECIALTY FINANCE BUSINESS”

Key to selecting a portfolio from the bank’s perspective, Ulum adds, is a reference portfolio with the critical mass required to justify the transaction costs involved. Many regionals are currently in the process of assessing which portfolios meet this criteria while also having losses that are low enough or predictable enough to be attractive to investors, she says.

“A lot of banks are trying to determine what the relative merits are of different portfolios between operational ease, the risk weights they’re holding and how attractive these assets are for investors,” Ulum says. “Some assets – such as auto loans – might be the easiest from an investor perspective, but they require a fair

amount of operational systems work. A portfolio that has a hundred commercial loans, on the other hand, is small enough that you could have a human do the reporting manually.”

One touted approach to building portfolios of suitable scale, is that clusters of banks pool their portfolios into larger transactions. Bisanz feels that, as a potential approach, it would not carry many risks. The key challenge, he says, is finding small banks that are willing to work together with investors.

In a typical non-pooled transaction, investors may have to rewrite terms of a deal they have agreed with one bank in order to satisfy the requirements of another bank, or vice versa. In the context of a multi-bank deal these dynamics can become more challenging, as Bisanz explains: “When you get five banks in a room, and say, ‘we are going to do this with one of you and the other four of you are going to have to accept the terms that have been negotiated,’ the others are likely to say they would just rather not do the deal.”

He continues: “It requires five banks who are highly motivated to do a deal to be willing to agree to the same terms. When you find five banks in that position, what is the likelihood that they have some commonality, whereby they all have a multi-family CRE problem, for example? There are only around 100 regional banks in the US that we are talking about. So you quickly stratify them into different categories.”

Bisanz says he believes pooling will happen eventually, but that it will require a level of

compromise over terms – a willingness that is yet to become apparent. Ultimately, what is needed is a shift in outlook in order for regionals to embrace the efficiencies of the multi-bank deal.

Despite the challenges or the approaches adopted, recent CRT issuance in the US tells us that momentum is building, albeit more slowly than many anticipated at the start of 2024. Regional banks have a very present need for capital enhancement and CRTs provide a tangible path to achieving this. With a handful of their peers issuing over the past year, the next wave now has case studies that can be presented to investors – once the internal questions have been answered. ▶

CHAPTER THREE: CROSS-POLLINATION

Within a prominent and well-documented context of growth in the US market, **Vincent Nadeau** investigates whether and how quickly will market terms standardise.

An increasingly favoured solution to banks' capital need, the US CRT market is often poised for substantial expansion. Historically, Citi has been a regular US SRT issuer, while JPMorgan and Goldman Sachs have tapped the market periodically. However, over the last twelve months regulatory tailwinds (combined with the failures of Credit Suisse, Silicon Valley Bank and First Republic, and increased interest in ways to better manage regulatory capital without selling assets below par) have permeated down to regional banks. Equally on the investor side, the stable and attractive returns that the CRT asset class has delivered over the years have made risk-sharing transactions increasingly popular.

Scalability

In practice, a CRT transaction is executed either through the issuance of a credit-linked note (i.e., a debt security) or a guarantee (e.g., credit insurance) or through the execution of a credit default swap. As part of the execution process, each of these documents is highly negotiated between the issuing bank and the initial investor(s) or counterparty.

For example, in a classic funded CDS structure (see Figure 1), originator and investor enter into a bilateral credit protection contract. This instrument may be drafted as a guarantee or credit derivative. In turn, investor pledges collateral in favour of the originator to a value at least equal to its maximum possible payment obligations under the protection, and is only paid to the originator (or available by way of enforcing the pledge) as and when losses hit the protected tranche. Alternatively, the collateral may be transferred outright and returned to the investor minus losses at maturity.

Even for similar deals (e.g., prime auto), the terms vary widely based on the positions of each party. This is unlike other areas, such as MRAs (a Master Repurchase Agreement is a standardised agreement used in the United States for repurchase transactions, also known as repos) and ISDAs (ISDA Master Agreement, a standardised form agreement that is used to document OTC derivatives trades), where standardised documents see little change in most transactions.

In very simple terms, the CRT trade makes sense for the originator if the cost of funding the securitisation, taking into account its capital saving, is cheaper than funding the assets on balance sheet. Therefore and conceptually, for the CRT market to be scalable to smaller banks and smaller investors, market terms need to standardise, and with that negotiation costs should drop considerably.

A buyer's market

Commenting on the recent broader CRT market developments in the US, Julie Gillespie, partner at Mayer Brown, highlights increased and substantial activity for the past two years, in line with the widely accepted view that the (re)entry of US banks provided a catalyst for growth for the CRT market as a whole. Regarding any potential standardisation of market terms, Gillespie notes: "Market terms for many asset classes within CRT still haven't standardised. In fact, I would not say it's been a quick process or that we are particularly close to standardisation within certain asset classes."

She adds: "Regarding auto deals for example, I would argue that recent structures have tended to standardise more and to follow or align with the traditional securitisation

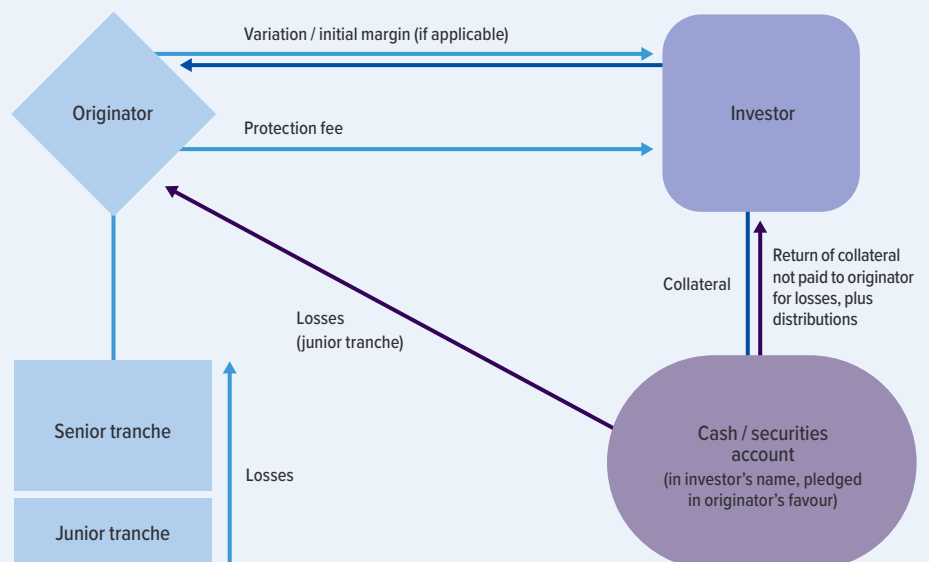


Julie Gillespie, Mayer Brown

documentation. However, within other asset classes, such as subscription loans, commercial loans and CRE deals, we have not witnessed a lot of standardisation. Therefore, I think that we are still a long way off from experiencing some comprehensive standardisation."

As she further expands on recent market developments, notably in the last 18 months, Gillespie argues that the CRT market is still a "buyer's market". On this matter, investors have repeatedly reported that, although the market is experiencing continuous growth, there is still a fundamental imbalance between supply and demand and a lot of untapped potential. Gillespie says: "Unsurprisingly, there is currently a lot of investor interest. Therefore, in terms of standardisation, we are still seeing protection buyers really improving on deals that they got six months ago ▶

Figure 1: Funded CDS structure



Source: A&O Shearman

Credit Risk Transfer Trades

With more than 100 structured finance lawyers in offices across the Americas, Europe, and Asia, Mayer Brown has one of the largest structured finance practices in the world – and with that size comes the knowledge and experience to tackle novel transactions like **credit risk transfer trades** (“CRTs”).

Mayer Brown’s structured finance and regulatory lawyers develop innovative CRT technology to help banks manage credit risk and investors acquire exposure to that risk. We use our decades of experience designing securitizations to efficiently problem solve for our clients.

Our team advises banks, investors, and intermediaries in structuring and negotiating CRTs. We have developed documentation for nearly every permutation of the CRT and can advise on emerging asset classes (e.g., sub lines, revolving) and client concerns (e.g., cross-border structures). Our sense of market color allows us to provide vibrant perspectives where others dabble in shades of gray.

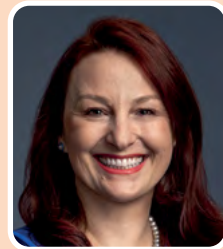
We also counsel banks and intermediaries on how to engage with regulators regarding CRTs. We prepare submissions for banks and directly engage regulators to explain why these transactions are a sound method of reducing risk. We also advise investors regarding the regulatory process, including the reasonableness of opposing positions.



Matthew Bisanz is a bank regulatory partner who advises banks and asset managers on complex instruments and transactions, including CRTs. He has interpreted the regulatory capital rules for over 10 years.



Julie Gillespie is co-leader of Mayer Brown’s structured finance practice. She routinely represents issuers and investors in structured finance transactions, with a focus on credit cards and other non-mortgage asset classes.



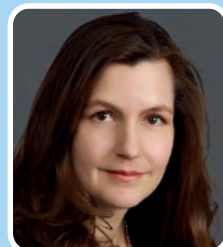
Eri Budo Uerkwitz’ practice focuses on complex financings and structured finance transactions, including CLOs, asset-backed lending and synthetic securitisation.



Ed Parker is head of Mayer Brown’s derivatives practice and structures CRTs in Europe and elsewhere. He also advises on complex and structured products, as well as insurance-linked derivative structures.



Sagi Tamir focuses his practice on representing investors in structured finance and derivative transactions. He has represented clients in numerous cash and synthetic collateralized loan, fund and debt obligations transactions.



Angela Ulum focuses her practice on advising banks and other issuers on CRTs and other structured finance transactions, with an emphasis on market participants in the auto and equipment sectors.



Sagi Tamir, Mayer Brown

or a year ago. Consequently, I feel that this is an area where, even if an issuer executed a deal at the end of 2023, the terms they're looking for today may be very different."

Sagi Tamir, partner at Mayer Brown, further identifies the market's apparent lack of maturity, as a clear hurdle for any imminent standardisation. He says: "Typically, for any product terms to standardise, in part, what you need is maturity of the product, and you need the deals that are being executed to be relatively public. They don't need to be public in the sense of a public offering, yet the more confidential they are, the harder it is for a product to standardise."

He continues: "And so if you look at the US market, there is still a meaningful number of deals that in terms of confidentiality or free access to deal information versus complete transparency to all market participants (including

“ALSO ONE HAS TO REMEMBER THAT, COMPARED TO ITS EUROPEAN COUNTERPART¹, THE US CRT MARKET HAS WAYS TO GO TO BECOME A MATURE MARKET”

those not participating in a given CRT transaction), the market is still more on the confidential side of things. Unsurprisingly, that gets in the way of standardisation. Therefore and reiterating what Julie mentioned above, I agree that we are ways off standardization except for certain asset classes that truly are being executed along the lines of a mature ABS programme."

Market maturity

Essentially, for market terms to standardise, it follows the linear logic that the market has to grow in maturity. Tamir adds: "Also one has to remember that, compared to its European counterpart¹, the US CRT market has ways to go to become a mature market. Additionally, a lot of banks have done and completed their first US deal in the last 24 months. Therefore it takes time for cross-pollination to operate and to start seeing true standardisation across banks."

However the maturity and trajectory of the US CRT market is often tied up with the regulatory

uncertainties surrounding the regulatory regime, namely decisions around Basel 3 end-game and the imminent Presidential election. Nevertheless, as current conditions remain very favourable to banks, the phenomenon of a protection buyer's market – as is the case at the moment – persists.

Market growth is often self-fulfilling. Issuing a first time CRT deal requires considerable effort and internal coordination, especially for banks below the largest tier. Moving forward, Tamir expects the snowball to start rolling down the hill. He says: "I am very optimistic as I think the fundamentals are there. We see the second, third, fourth tier banks looking to understand the product and its merits. Once a bank has completed an inaugural transaction, repeat issuance is much easier (and more affordable due to the amortization of program setup costs). Based on the numbers of calls and the level of interest we are handling, I fully expect the market to keep on growing." ▶

¹ Last year, the European Systemic Risk Board stated that "the SRT market is **now mature** and the factors underpinning its growth and functioning should be well understood by regulators and policy makers." Occasional Paper Series No 23, *The European significant risk transfer securitisation market*.



CHAPTER FOUR: A GROWTH MARKET

Mortgage insurance is as old as the hills, but the provision of financial guarantees or insurance policies on pools of home loans to secure capital relief as a tool of the significant risk transfer (SRT) market is of much more recent vintage. **Simon Boughey** looks at the growth and structural developments in the unfunded mortgage SRT market, but also the reasons as to why unfunded insurance provided to private banks in the US is still subdued.

Arch wrote an unfunded mortgage SRT transaction with ING in 2018, and this is generally thought of as the starting point of the market. Supranationals like the European Investment Fund had provided guarantees before this date, but Arch started the ball rolling for private insurance and reinsurance companies.

Arch Capital Group Ltd writes insurance, reinsurance and mortgage insurance on a worldwide basis with a focus on specialty lines. The business is Nasdaq-listed and a member of the S&P 500 index.

Since the first unfunded trade in 2018, other names such as Munich Re, Fidelis and Renaissance Re have entered the space as well, but Arch remains a leader with a ~35% market share in 2023, based on data from the International Association of Credit Portfolio Managers (IACPM). The same body also says that protection provided by insurance companies on tranches in 2023 totaled about US\$1 billion.

Although these firms provide guarantees or policies on a variety of portfolios, including, for example, high quality corporate and SME loans, mortgage remains very much a core asset class for SRT transactions. All of the trades written by Arch to date in 2024 have provided protection on mortgages for issuers across Europe.



Ruairi Neville, Arch International Mortgage

This is an asset class Arch understands intimately; it's in its DNA. It makes sense that this is where it is most comfortable playing.

"Mortgage is a key tenet of Arch's overall strategy", says Ruairi Neville, head of European origination for Arch International Mortgage.

"We're the largest and only globally diversified mortgage insurer in the world. Along with our European SRT business, our global presence includes primary mortgage insurance operations in the U.S. and Australia along with our GSE Credit Risk Transfer business in Bermuda."

“THE STRUCTURES OF TRANSACTIONS ARE VERY MUCH DEAL SPECIFIC AND DEPEND ON THE BANKS’ INDIVIDUAL MOTIVATIONS”

Since its first transaction in 2018, Arch has completed almost 30 unfunded SRT transactions and has now about US\$1 billion of limit out in the market. Arch has the flexibility to write SRT as either a Financial Guarantee or an Insurance Policy and has concluded trades using both formats, says Neville. It is at the banks' discretion as to how they wish to classify the trade. In some regulatory jurisdictions, guarantees work better, and in others insurance policies are preferred.

Mortgage SRT is typically transacted on an unfunded basis. Insurers make use of their generally robust credit rating to execute these deals and keep liquid assets on the balance sheet. Arch and Renaissance Re are both rated A+ by S&P and Munich Re has an AA S&P rating.

Asset management firms are not usually as well rated as this. Ares is rated BBB, for example.

They are obliged to do funded SRT deals, but generally also have disposable capital at hand and run bespoke SRT funds.

Insurers also have a greater appetite for longer-dated assets than asset managers.

"Arch is very comfortable covering long-dated risk", Neville says. "Many of the SRT trades Arch has written have maturities in excess of 10 years".

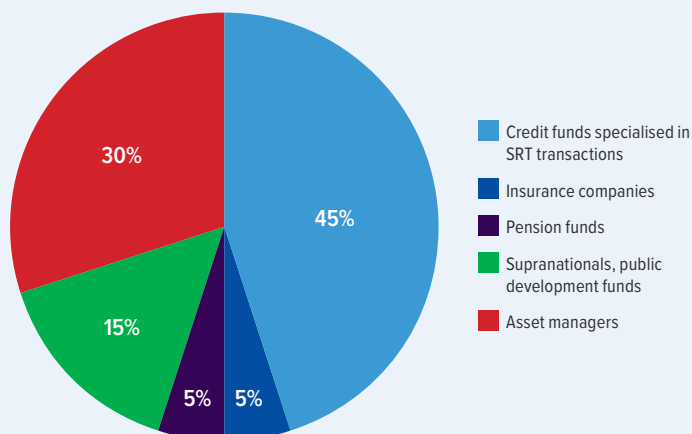
The average asset manager which likes SRT investment would have wanted to invest and reinvest this capital several times in this passage of time.

Insurers also tend to have a lower cost of capital than traditional funded buyers, so they achieve more efficient funding at lower coupons. This, clearly, is a large advantage to a lender seeking to attain capital relief on a portfolio of mortgages.

Arch usually works directly with the bank owning the assets. Many of the SRT trades the insurer wrote in the last 24 months have been repeat trades with existing clients.

"Building a strong network of trusted partners is critical to our success in the SRT arena", says Neville. "

Figure 1: SRT Investors: Key investor categories active in the SRT market



Source: Survey ECB data (June 2023), BoA Global Research

prefer low risk pools like mortgages or vanilla corporates, often with a focus on granularity and consistency. They're also generally more interested in the more risk-remote pieces of risk like senior mezz and not first loss, while noting their ability to transact the most junior tranches is steadily increasing as familiarity grows", says Robert Bradbury, head of structured credit execution and advisory at London-based Alvarez and Marsal.

Arch's SRT trades are written from both Dublin and Bermuda. Arch has invested significantly in its European SRT operations over the last few years with key hires in the underwriting, legal and actuarial teams, while also having the benefit of being able to leverage the expertise in mortgage credit that exists across the broader Arch Group.

Insurers also claim that pricing can be very competitive compared to funded investors. They say they have less volatile premium requirements and can offer more consistent pricing on an ongoing basis. This is especially pertinent in an era when a new raft of relatively untried investors has entered the SRT market, sowing discord among the more established, and perhaps more trusted, buyers. These newcomers will perhaps fade away into the distance



Robert Bradbury, Alvarez and Marsal

when SRT investment loses its lustre in comparison to the alternatives, say the critics.

The reach of the unfunded insurance guarantee is extending into further reaches of the SRT market as well. In 2022, Arch secured a mortgage SRT transaction with a large Spanish bank and since then has done several trades with Iberian counterparties. It is now the largest provider of unfunded mortgage protection in the region.

“THE FACT THAT INSURERS ARE NOT CURRENTLY CONSIDERED ELIGIBLE PROTECTION PROVIDERS FOR THE PURPOSES OF THE STS FRAMEWORK IS A DISADVANTAGE”

In the same year, it wrote two unfunded mortgage deals with counterparties in central Europe and this year did the first mortgage trade with a Nordic bank. Italy has been a core market for the firm since it began providing cover for Mortgage SRT.

This is still, however, a relatively small corner of the European SRT market. The entire unfunded market, which includes guarantees of other assets in addition to mortgages, constitutes, perhaps, between 5% and 7% of the whole (see Figure 1).

“It's only a small proportion of the overall deal flow. Insurer appetite for risk is lower and there are fewer broadly relevant deals as a result,” says Bradbury.

The relatively small size of the mortgage SRT market is also relevant because there are

some disadvantages to unfunded protection provided by insurers. Firstly, EU regulation currently disallows these deals from STS qualification. The framework for “simple, transparent and standardized” securitization was introduced in early 2019, and it set out the process by which certain institutional investors could benefit potentially from more favorable regulatory capital treatment for STS securitization exposure.

Certain investors, including insurers, were excluded from these provisions. As law firm Norton Rose Fulbright has written in its guide to STS securitization, “The SPR (Securitization Preferential Treatment), which focuses on CRR (Capital Requirements Regulation) regulated credit institutions and investment firms, does not afford the same STS capital relief to other institutional investors such as pension funds, insurance and reinsurance undertakings.”

In the same guide, it also notes that while the European Commission (EC) has made “encouraging noises” about extending STS capital relief to insurers, the effect of the new STS framework “may be muted if insurers are effectively excluded from benefiting from preferential capital treatment.”

Some six years after this piece was written, the adumbrated encouraging noises have not yet been transfigured into action. Things happen slowly in EC regulation.

The lack of STS categorization also makes tranching and structuring less efficient as it changes the risk weighting floor adversely and removes more favourable regulatory inputs, notes Robert Bradbury.

Neville is aware that this is a problem. “The fact that insurers are not currently considered eligible protection providers for the purposes of the STS framework is a disadvantage”, Neville says. “Insurers represent highly regulated and well-capitalized counterparties who can bring significant diversity to the total investor base. The exclusion of insurers from STS trades is not conducive to furthering securitization in Europe, and we hope this will change in the near future”.

In addition, issuers must hold counterparty risk weight against unfunded guarantors,



Michael Shemi, Guy Carpenter

further reducing the efficiency of the transaction. However, argues Neville, this is a relatively minor burden for issuers.

“The protected tranche may only be about 5% and the bank will need to hold capital against our A+ rating, so it’s not a huge number,” he says.

Despite the caveats, the provision of guarantees or insurance by insurers is a growth market. Once banks have done one deal, they are likely to do more. Putting all the pieces in place before an unfunded SRT deal can go ahead is a considerable internal labour, and it doesn’t make a lot of sense to do one and then retreat from the sector.

“Each year, we onboard new counterparties. All the banks we deal with have done multiple deals or are looking to do multiple deals”, Neville says.

In the U.S., as is not uncommon, things are very different. Insurers and reinsurers, including Arch have worked with GSEs to provide credit risk transfer of exposure to mortgage assets since 2013 through the agency credit insurance structure (ACIS) programme at Freddie Mac and the credit insurance risk transfer (CIRT) programme at Fannie Mae.

In August 2024, Freddie Mac concluded its 100th ACIS transaction, and in the last 11 years has protected more than US\$2.5 trillion of unpaid principal balance of mortgage loans via US\$35 billion of ACIS coverage with more than 60 (re)insurers. Each deal normally has about 25 insurers and reinsurers.

Fannie Mae has executed five CIRT deals so far in 2024, the fifth deal in late June transferring US\$337 million to 27 insurers and reinsurers. Since the inception of CIRT, the GSE has acquired approximately US\$27.6 billion of insurance coverage.

But, unfunded insurance provided to private banks a la the European model hasn’t got to first base.

According to section 12 CFR 217.2, the portion of Regulation Q that deals with capital adequacy, insurance companies are not permitted to act as “eligible guarantors”. These rules were devised in the wake of the financial crisis of 2008/2009, in which several firms that provided mortgage insurance failed.

Insurers could participate in the mortgage CRT market in the U.S. by providing cash collateralized positions in the CLN market, but for the bulk of insurers it doesn’t make sense to lock up capital for the duration of a deal.

So, for the time being, this leaves the mortgage CRT market in the U.S. high and dry. A potentially vast pool of capital is locked out of the space. As Michael Shemi, North America structured credit leader at Guy Carpenter in the U.S. notes, “I think reinsurance companies are a huge source of steady capital for CRT as buy-and-hold counterparties. If the GSE CRT market plateaus, or even declines over the next year, then reinsurers would be looking to deploy their capital elsewhere, and bank CRT would be a great place to do it. Some feel that the market would benefit from further clarity about the treatment of reinsurers as eligible guarantors in the U.S. regulatory framework.”

But for the time being, the mortgage CRT market outside that written for the GSEs is high and dry, and it will be until there is regulatory change. Not unlike their European counterparts, however, U.S. regulators tend to move slowly and unpredictably.

“I THINK REINSURANCE COMPANIES ARE A HUGE SOURCE OF STEADY CAPITAL FOR CRT AS BUY-AND-HOLD COUNTERPARTIES”

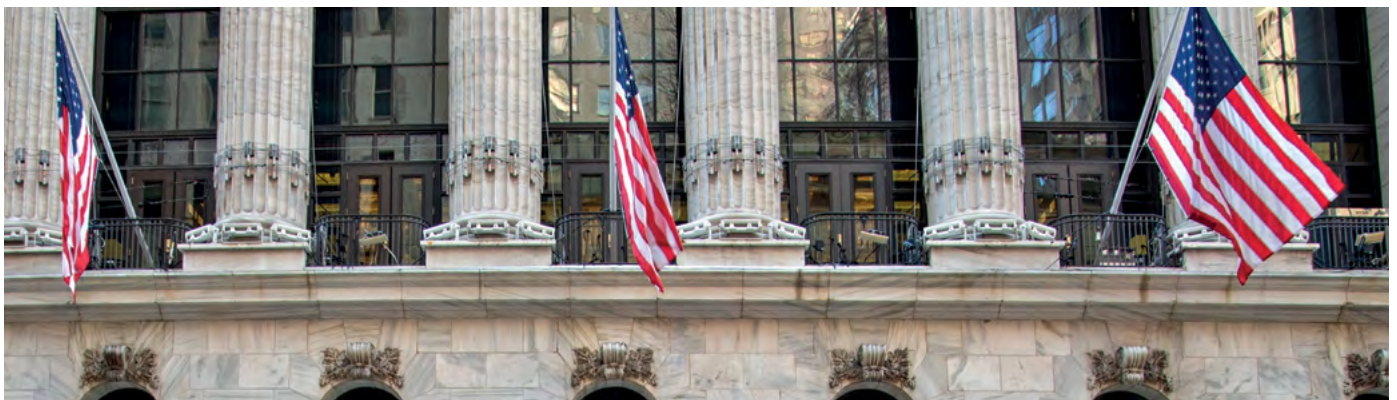
One possible way around this is for a European subsidiary of a U.S. insurer to write the protection as they are not required to comply with US law.

“If a London branch of a U.S. bank bought a guarantee from an eligible insurance company in London, this would tick the boxes for reg cap treatment in the US,” explains Matt Bisanz, a partner in Mayer Brown’s banking and finance practice.

However, Bisanz says, there is currently little inclination among bank issuers to devote the time and resources to explore this particular avenue.

While it would be a mistake to describe the European mortgage CRT market as yawning, it is growing and offers a new and different outlet for lenders seeking to achieve capital relief of mortgage assets. In 2023, Arch provided guarantees and insurance for lenders in northern Europe, southern Europe and the DACH region (Germany, Austria and Switzerland). In all, it has clients for unfunded capital relief transactions in 11 different EU and non-EU geographies.

These lenders will prove to be repeat customers, so the pool is set to expand. Not dramatically, perhaps, but inexorably. ▶



CHAPTER FIVE: LATAM AS THE NEW EMERGING MARKET

Talking to key players, **Joe Quiruga** explores the burgeoning Latin American SRT market.

Thanks to trailblazing deals issued by Santander, the Latin American (LatAm) SRT market is open for business and is perhaps the sector's most promising emerging market. Enabled by multilateral development banks (MDBs), Santander has completed at least three transactions in two years with deals in Brazil, Mexico, and most recently the SCI Awards winning "Project Patagonia" in Chile.

Looking back, SRT is not entirely new to the region, but is instead gathering steam after a long period of dormancy. As Mascha Canio, head of credit and insurance linked investments at PGGM explains: "In 2007 we did an SRT transaction in Brazil with Banco Real, who was part of ABN Amro Bank. Of course, a lot happened in the meantime with the GFC and other events."

Of course, jurisdictions where SRT is relatively untested pose different challenges to those experienced in established markets. How does a new issuer or investor navigate a regulatory environment still in development, deal with risk, and establish relationships with key stakeholders?

Regulations

It is helpful to look at LatAm's SRT market less as one homogenous region like Europe, and instead as one divided along regulatory lines. Among the jurisdictions where transactions have been completed, some have securitisation rules in place and some do not.

In jurisdictions where the rules have been implemented, LatAm transactions look very similar to their European counterparts. As



Mascha Canio, PGGM

Edmund Parker, partner at Mayer Brown, explains: "Where the Basel 3 capital rules are implemented, you can structure a synthetic securitisation referencing an asset class, creating an unfunded CDS guarantee from a multilateral institution, and tranche it to achieve better regulatory capital."

This is not to say that it is impossible to do deals in jurisdictions without the Basel 3 rules, however these can only be done by multinational banks to achieve capital relief on a group level – similar to how there have been SRTs done on Norwegian assets prior to the implementation of the SecReg in the EEA, but only by multinational banks with assets in the jurisdiction and not by local players with no cross-border presence.

Another key barrier caused by the lack of an ECB-like regulatory body is that regulators can (and have) changed their minds about SRT. Mexico had SRT rules in place in 2018 when Santander completed its first transaction in the jurisdiction. By the time the second rolled around, Mexico had repealed them.

Therefore a lack of securitisation rules does not make doing deals impossible, but having them in place does make it easier. As Parker explains: "Brazil has implemented rules allowing for capital relief where there is a credit risk mitigant or an unfunded guarantee from a multilateral institution. This provides an enormous opportunity for issuance."

Practical considerations

Emerging markets demand more consideration than established ones. Among these is how the regulatory environment evolves from its infancy into a system which enables SRT transactions to take place.

“BRAZIL HAS IMPLEMENTED RULES ALLOWING FOR CAPITAL RELIEF WHERE THERE IS A CREDIT RISK MITIGANT OR AN UNFUNDED GUARANTEE FROM A MULTILATERAL INSTITUTION”

Parker adds: "Obviously if you don't have the rules in place at a jurisdictional level you can't get capital relief at a local level. Institutions can sometimes find it worthwhile to do the deals even without the rules in place, if the capital relief obtained at group level is sufficiently appetising."

This can create barriers to getting a market up and running. Xavier Jordan, chief investment officer of global capital markets at IFC, explains: "A fundamental reason that Europe is so effervescent is that entities like the ECB create overarching multi-country regulatory frameworks. As such, issuers in other regions including LatAm have to rely on single country regulatory scaffolding."

European banks who have issued the asset class successfully in Europe therefore join with MDBs like the IFC to open up new jurisdictions.

Parker says that where local rules track European CRR legislation it can be helpful for issuers to have a trusted European counsel who can facilitate a strong relationship with either local counsel or the local regulator. This allows guidance to be provided to the local regulator as to how gaps are dealt with under the corresponding European rules. Jurisdictions which are yet to see transactions can benefit from looking to the European framework. For example, the EBA's published Q&A on CRR provides publicly available regulatory interpretations of many aspects of regulatory capital rules, which can be most helpful to any local regulator as it forms its own views.

Parker further explains: "The rules in Europe are massive and complicated. CRR itself is hundreds of pages long, and it is supplemented by technical standards, guidelines, EBA reports ▶

THE HOTTEST TICKET IN TOWN: REGULATORY CAPITAL RESERVATIONS OF AUTHORITY

Last year, staff of the Federal Reserve issued guidance on how the banking organizations it regulates can request a reservation of authority under the regulatory capital rules. While even the name “reservation of authority” carries an air of linguistic mystique, a reservation of authority is little more than a determination by a US banking regulator that a banking organization may assign a different risk weight to an exposure than otherwise would be required under the regulatory capital rules. In the context of credit risk transfer (“CRT”) trades, a reservation of authority is the basis for a banking organization to treat a directly issued credit-linked note (“CLN”) transaction as a synthetic securitization and use the simplified supervisory formula approach to assign risk weights.

In this article, we provide background on the reservation of authority process and discuss what we have learned from guiding several clients down the path to approval.

Background

The first interagency reservation of authority provision appears to have been included in a 2001 rulemaking that addressed the securitization provisions of the capital requirements. The preamble discussion stated that the development of novel transactions that did not “fit well” into the existing capital requirements warranted clarification that the regulators had the authority to determine “the appropriate risk-weight for assets and credit equivalent amounts and the appropriate credit conversion factor for off-balance sheet items” on a case-by-case basis. Notably, the preamble also stated that the regulators’ exercise of this authority may result in higher or lower capital requirements.

As part of the Basel II rulemakings in 2006-2008, the regulators adopted (or, in the case of the standardized approach to credit risk, proposed to adopt) more detailed reservations of authority. The regulators explained that the general intent of these reservations of authority was to allow the regulators to require a banking organization to hold more capital or maintain higher capital ratios than would be required under the capital requirements. However, it is not entirely clear from the language of the reservations of authority that a regulator determination must result in a less favorable outcome for a banking organization.

The Basel III rulemakings from 2011-2013 largely adopted the same language for reservations of authority from Basel II. On a somewhat interesting note, the preamble to the final Basel III rule includes a footnote explaining that the regulators may exercise the reservation of authority provision to permit a banking organization to use more favorable capital treatment for securitizations of

small business loans and leases on personal property that is transferred with retained contractual exposure. Further, the 2019 tailoring rulemaking explicitly noted that the regulator may use the reservation of authority provision to “increase or adjust requirements as necessary on a case-by-case basis.”

2023 Staff Guidance

In recent years, many banking organizations have sought to use synthetic securitization to transfer credit risk and to reduce the amount of risk-weighted assets against which they must hold capital. This is because synthetic securitization allows the banking organization to reduce its risk of a credit loss while retaining the entire asset on its balance sheet and avoiding mark-to-market/transitory loss realization on sale. However, only a few CRTs were executed in the United States. The often-cited reasons for this sluggishness were a lack of regulatory guidance and slow regulator responses to requests from banking organizations.

In September 2023, the Federal Reserve staff issued guidance stating that CLNs that are directly issued by a banking organization or its consolidated subsidiary can be an effective way to transfer credit risk. However, the guidance explained that Federal Reserve staff have concerns that such CLNs fail the regulatory criteria that a synthetic securitization must (i) include a guarantee or credit derivative and, in the case of a credit derivative, the derivative must be executed under standard industry credit derivative documentation and (ii) if the credit risk mitigant is collateral, it must be property in which the note issuer has a collateral interest.

To address these concerns, the guidance states that a banking organization may request a reservation of authority under the capital rules to assign a different risk-weighted asset amount to the reference exposures of a direct CLN.

Reservation of Authority Process

The guidance directs banking organizations to contact supervisory staff at the appropriate Federal Reserve Bank to request a reservation of authority. Typically, a banking organization will meet informally with supervisory staff and raise the topic of issuing a synthetic securitization. Based on supervisory feedback, the banking organization will prepare a submission that requests the reservation of authority. The contents of the submission vary from deal to deal but often include a detailed description of the direct CLN, including a term sheet, draft issuance and administration documents, a draft of the hypothetical credit derivative or guarantee, and other supporting documents. It is a careful balance between ensuring all relevant terms are disclosed and not overwhelming staff with irrelevant or repetitive materials.

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This request will be reviewed by the Federal Reserve staff, who may determine to grant the request pursuant to authority delegated from the Federal Reserve Board. While they will review the entire submission in detail, our experience has been that they are most focused on the features that affect how the CLN functions as a risk-mitigant. This is most likely because they want to ensure that the banking organization is both transferring credit risk to the protection provider and receiving a benefit from the protection provider that cannot be impeded by market events, counterparty disputes, or legal proceedings. Depending on how well a banking organization and its counsel have structured the CLN and prepared the submission, approval times can range from a matter of weeks to more than a year.

Limitations

A reservation of authority is valid only for the banking organization to which it is addressed. This reflects the fact that the Federal Reserve has determined that the specific bank organization’s actual risks are not reflected by the generally applicable risk weights in the capital rules.

A banking organization may use a reservation of authority for multiple direct CLNs as long as each transaction is structured and documented in a substantially identical manner to the approved transaction.

Further, at any given time, a banking organization may not have outstanding direct CLNs where the aggregate outstanding reference portfolio principal amount exceeds the lower of 100% of its total capital or \$20 billion. However, a banking organization should be able to execute other forms of CRTs regardless of the limits in the reservation of authority if they satisfy all of the requirements in the capital rules (e.g., CLNs issued by a non-consolidated SPV).

Conclusion

Navigating the reservation of authority process requires a banking organization to understand as much about regulatory lore and supervisory relations as it does about the economic terms of a CRT. Failure to thoughtfully engage with regulators and prepare a tailored submission may result in numerous follow-up questions and extended processing times. These delays can be disastrous for obtaining timely approval for CLNs that must be issued by the end of a quarter (or may already be outstanding).

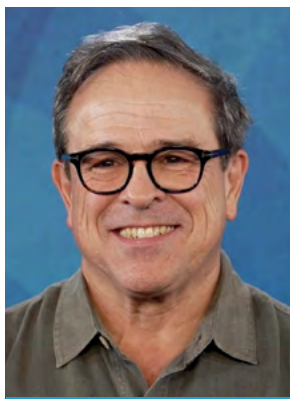
By Julie Gillespie and Matthew Bisanz. Ms. Gillespie is the co-leader of Mayer Brown’s structured finance practice. Mr. Bisanz is a bank regulatory partner with Mayer Brown. They can be reached at jgillespie@mayerbrown.com and mbisanz@mayerbrown.com, respectively.

and Q&As. New jurisdictions might have only have a fraction of that detail implemented. Having an insight into how the same issues have been dealt with in Europe can greatly benefit a local regulator looking to improve its first few synthetic securitisations.”

He adds issuers should be careful in choosing their counsel on this: a tactful and helpful approach, which points to helpful provisions in Europe, is likely to be most successful.

For investors, the attractiveness of SRT is the same in LatAm as it is elsewhere. Canio explains that for PGGM: “SRT allows you to access exposure to assets you typically can’t find elsewhere, because of the types of clients that banks have such as corporate clients and revolving credit facilities. There is a lot of operational hassle with clients being able to withdraw and prepay, etc. This doesn’t fit well with how institutional investors are set up, but it’s an interesting product to have exposure to.”

Another interesting element for PGGM is the multiple contact points SRT issuers have with borrowers. “Term loan and bond investors have a more limited flow of information, and hence we



Xavier Jordan, IFC

parties, the issuer, the regulator and the investor need to agree on the majority of points for these transactions to work.”

What about MDBs?

As it does in Central and Eastern Europe, the IFC is playing an important role in opening up the LatAm market. The MDB can front up

importance when convincing regulators of its merits.

He notes: “This comes down to having fewer defined regulations. When you have quite light rules, simplicity is best.” Parker adds that MDBs tend to have good understanding of the region and are well-placed to assess credit and reference portfolios.

The guarantee can also encourage the involvement of investors who may otherwise be unable to participate. As Canio explains: “For us, one challenge is we do put up cash while we don’t want to take the credit risk to the issuer, and therefore the collateral needs to be very highly rated. That’s where an MDB could come in to guarantee or to issue collateral in, for example, Mexican pesos.”

The IFC also pursues a developmental impact angle to its transactions. Jordan summarises the role of the IFC like this: “We fundamentally prefer to introduce new asset classes and always need to have a thematic impact narrative in the investments we make. We introduce debut transactions to the market, and also regulators to the product to the extent it’s necessary. Once the first deal is complete, we can continue to be a strategic investor in the space to the extent where we add new dimensions to it in terms of development impact as far as redeployed RWA/capital is concerned.”

The impact narrative is another key consideration for the IFC, according to Jordan: “ESG is a twofold issue. We cannot take exposure to ESG eruptions in reference portfolios – which means SMEs are tactically advantageous as there’s less ESG risk in the asset class than, say, infrastructure. We also have the impact we want to make – if it’s SME loans we might encourage more SME lending, on other portfolios we might encourage more green lending, or if the underlying asset class is ESG loans to start with then sustainability features are already likely baked into a reference portfolio.”

Jordan says the key themes IFC likes to focus on for the moment are the environment, gender and SMEs. Sometimes the jurisdiction pushes the IFC towards one of these aims, for example in Poland a lot of energy is generated by coal in a time when much of Europe is seeking

“IF WE CAN IDENTIFY SOMEONE TO TAKE THE RISKIEST CAPITAL PORTION, IT ENABLES US TO DO MUCH MORE BUSINESS THAN MIGHT OTHERWISE BE THE CASE IN CERTAIN CIRCUMSTANCES”

see value in that which we typically see reflected during due diligence.” The risk-return profile is also of interest, as is the change SRT issuance can ignite through conditions such as ESG requirements attached to transactions.

Then there is the inevitable matter of patience. Deals in new jurisdictions can, and often do, take years between inception and completion. Investors need to be as generous with their time as they are with their cash in such scenarios: “Where possible I think you do want the regulator to allow for capital relief, which requires the regulator to understand the product and put up a framework to support it. This takes time.”

Although this is not a role investors are expected to take, Canio finds that involvement in the process can be helpful: “The relationship between regulators and banks is like an enforcer so there’s a general mistrust between the two. The investor can help remove some of that mistrust if it has been involved in the market for a number of years. In the end, all three

to 100% of protection on an underlying credit portfolio and then syndicates junior risk associated with the latter to other investors. Alternatively, it can and does invest in mezzanine tranches directly – with the possibility of doing so with the junior tranche on the horizon.

Jordan explains how the former alternative works: “Multilaterals could take SRT technology and graft it onto vanilla risk sharing. If we can identify someone to take the riskiest capital portion, it enables us to do much more business than might otherwise be the case in certain circumstances. If you work with smart investors in this way, and there are quite a few who are very interested in diversifying beyond Europe, it can bring a lot of value to the market.”

The value goes beyond the monetary. Parker points out that an MDB’s guarantee on a slice of the reference portfolio makes for an easy-to-understand structure compared to the more intricate SPV model. This improves the explainability of the product, which is of paramount



Edmund Parker, Mayer Brown

to transition to renewable energy, making low-hanging fruit of an environmental focus. “Project Patagonia” in Chile frees up capital for women-only mortgages.

However the bank ultimately decides which ESG target to assume: “We can’t jam a thematic lending story down their throat. We typically sit down with the bank and set out our priorities and ask what theirs are. But to a certain extent we’re leaning on an open door, as ESG imperatives are not something we have to convince a lot of banks to consider seriously.”

He adds there is an incentive which keeps issuers “on-target” in terms of RWA/capital redeployment trajectories. In the majority of cases, the IFC does deals with WALs of 3-4 years, meaning capital relief needs to be extended. “If things aren’t on a positive trajectory, we won’t be particularly amenable to such extensions.”

The future

In addition to Mexico, Chile, and Brazil, Colombia and Peru are additionally considered to be of interest for issuers. This is mostly driven by US banks which either already have a presence in LatAm or which desire to advise or act on behalf of issuing banks in the region.

Parker explains: “The interest we’ve had from US clients is palpable as that’s where a lot of LatAm desks tend to be, partially because of dollarisation. Arranging a transaction on behalf of a local bank in LatAm could be appealing.”

“THE INTEREST WE’VE HAD FROM US CLIENTS IS PALPABLE AS THAT’S WHERE A LOT OF LATAM DESKS TEND TO BE”

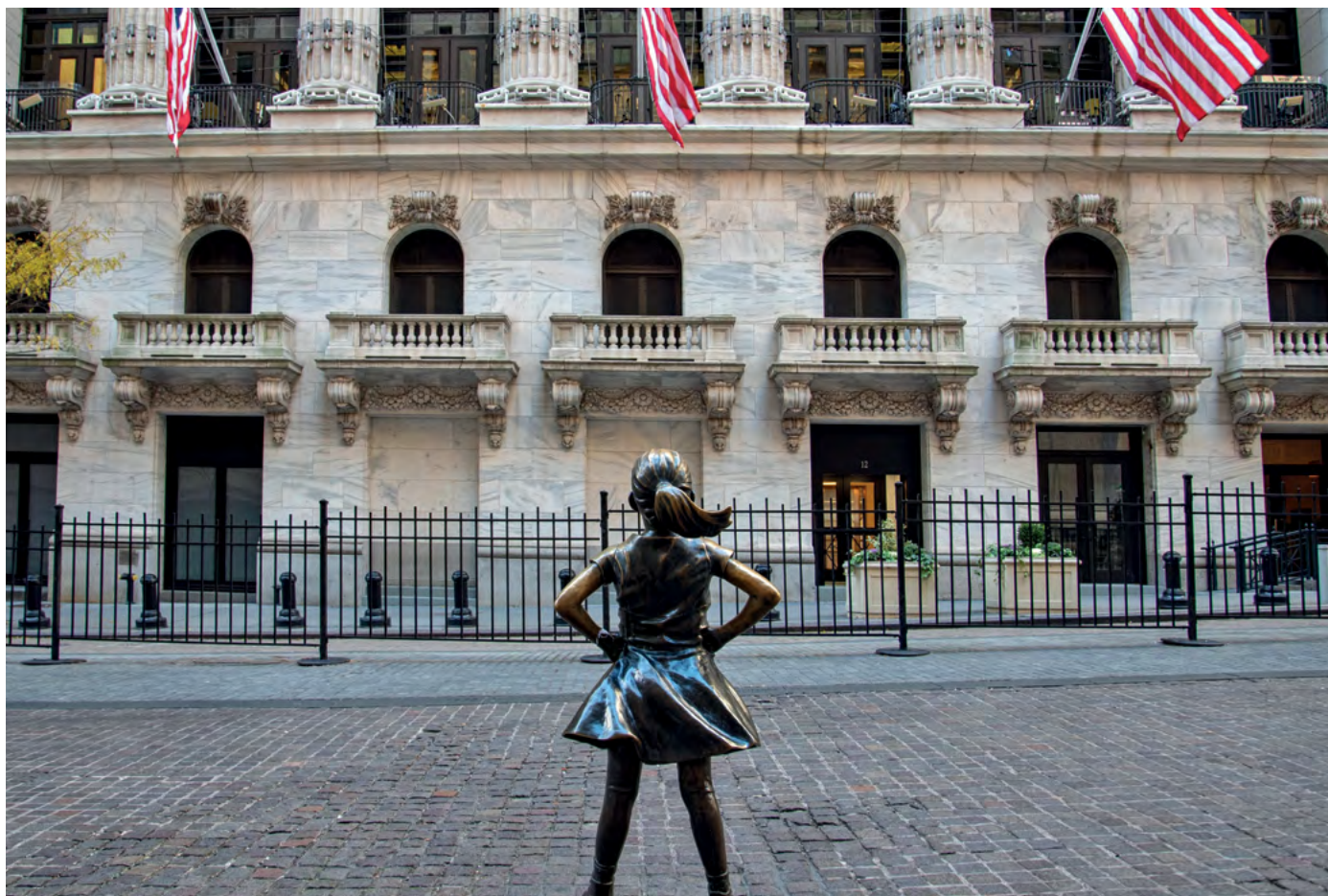
He has previously said Brazil has the potential to reach the volumes seen in European jurisdictions like Poland and Austria.

Canio explains what investors would look for in a new market: “We would really look at the institution itself first – their market standing and the size of the book. That’s very important. Where the bank is, because there are some countries like Venezuela where we don’t want to have any exposure. You want a relative level of economic and political stability, because there are some countries where the risk isn’t worth it.”

In general, the rule of thumb seems to be large economies as well. The exception to this rule seems to be Argentina. Suggestions that economic reforms by its current president would make the market more investable were met with the cold shoulder. It will likely be considered off bounds until it reaches long-term political and economic stability.

In short, LatAm has gathered steam as the emerging market to watch, overtaking Asia and the middle east which had been considered the next big thing besides the US. Canio says that LatAm may currently be the most promising emerging market for SRT in terms of jurisdictions which have completed transactions – although she adds “We’ve been working on more than just LatAm – I think they’re all exciting”.

For Jordan, Asia is especially worth considering: “Japanese banks already use this product. While the banks are well capitalised, you might see them take an interest on behalf of their emerging market franchises. For example, a bank in Singapore may be interested in achieving group-level relief for subsidiaries in, say, Indonesia. You could also see Japanese banks buying protection on regional portfolios. This is me guessing the future, but outside of the very sophisticated South African banks, Asia is the best shot.”





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