The Collins catalyst

The increasingly onerous impact of the Collins Amendment is catalysing US banks to consider capital relief trades. **Simon Boughey** investigates.

The take-off of the US capital relief trades (CRT) market has been predicted for several years. But the increasingly onerous impact of the ramifications of the Collins Amendment could provide the tipping point.

This amendment to the 2010 Dodd-Frank Act, named after Senator Susan Collins of Maine, requires US banks that are entitled to use their own internal risk-based (IRB) models to determine risk weighted assets (RWAs) to also calculate RWAs according to the standardised methodology and to then apply whichever of the two is the toughest. Banks would thus be prevented from use of sleight of hand to reduce the value of assets and thus lessen capital requirements, and in a post-financial crisis world this was deemed a primary objective.

The standardised approach to RWA calculation had been initially unveiled as part of the capital adequacy standards of Basel 2, which were quickly superseded by the financial crisis and then Basel 3. According to Basel 3, the advanced or IRB-based approach could only apply to entities that have consolidated assets greater than US$250bn or balance sheet foreign exposures greater than US$10bn.

The Collins Amendment was codified into US financial law in the US acceptance of Basel 3 in 2013, but for a number of years its impact was tangential. The value of RWAs as calculated by IRB models was always higher than under the standardised approach. However, as banks began taking riskier assets off the balance sheet, a shift occurred: the standardised approach began to value RWAs more highly than through IRB models.

In this way, the Collins Amendment – a backstop designed to prevent banks going off-piste – had become a binding constraint. In its investor day of February 2019, JPMorgan addressed the issue head-on: a chart shows that somewhere around the end of 2016, the value of RWAs calculated by the standardised approach became greater than through the advanced approach. By the end of 2018, the gap was over US$100bn *(see Figure 1)*.

Indeed, research conducted by Seer Capital suggests that at the top four US commercial ▶

banks – Bank of America, Citi, JPMorgan and Wells Fargo – the average differential between the calculation of RWAs according to the standardised methodology and by the advanced approach is now 4%. Clearly, 4% of trillions of dollars is a lot of money, with profound implications for capital requirements.

"In 2015, RWAs as calculated by IRB models, were higher by a total of US$160bn, so there has been a significant shift," explains Terry Lanson, an md at Seer Capital. By the end of 2019, RWAs calculated under the standardised approach exceeded those calculated under the IRB approach by an aggregate of US$210bn across those four banks.

Consequently, there is added and growing incentive to reduce RWAs through the use of capital relief trades, bringing them more in line with valuation according to the standardised approach. Moreover, as the standardised approach has become the binding constraint, there is added incentive to take higher quality assets off the balance sheet as standardised calculation is something of a blunt instrument and does not differentiate between differing asset qualities.

It is worth noting in this regard that the US application of the standardised approach is also more onerous than the European version. For example, all loans secured by consumer debt – whether they are credit card loans, auto loans or personal finance loans – are given a 100% risk weighting, irrespective of the credit of the borrower. Equally, all first lien residential mortgages receive a 50% weighting irrespective of type, while all corporate loans receive a 100% weighting.

"Basel 3 does allow loans to be treated somewhat differently under the standardised approach, but in the US all corporate loans are 100% risk weighted, notwithstanding the fact that some loans might be highly rated and may have a much different risk profile. The IRB approach assigns some corporate loans risk weighting of 20% or lower if they have low default probability, low loss given default and short tenor," says Lanson.

So banks are incentivised to construct pools composed of higher quality assets as they receive exactly the same degree of capital relief as if the pools contained lower quality assets, with the added advantage that they are an easier sell to investors at a more aggressive price.

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Terry Lanson, Seer Capital

This phenomenon has been demonstrated in the relatively few syndicated transactions seen in the US over the last year or so. JPMorgan issued several trades referencing its corporate loan book, while Goldman Sachs issued its Absolute trade in September last year.

"What we saw in the JPMorgan and Goldman Sachs trades were super high quality loan portfolios, so absolutely not the type of portfolios that European banks would have hedged. There is no benefit to doing lower quality loans as, under the standardised approach, all loans are treated the same," explains Olivier Renault, global co-head of FIG solutions at Citi in London.

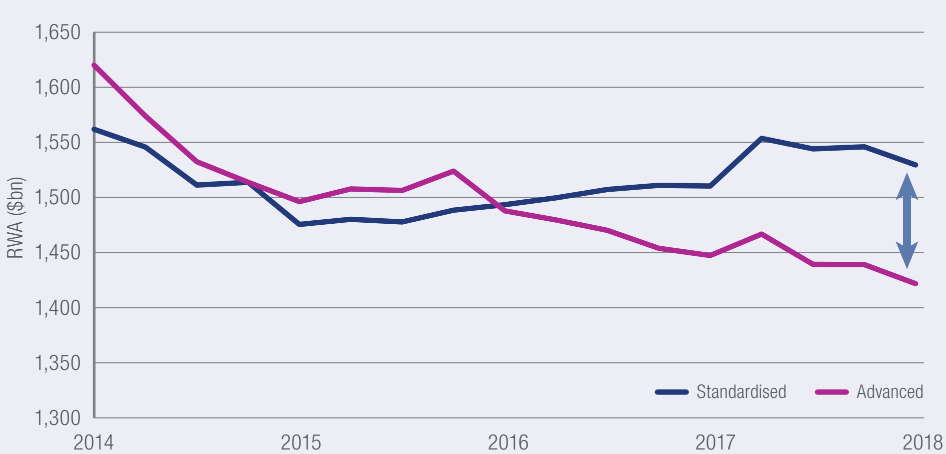
Tranche thickness was another giveaway that these trades seen in the US were designed to reduce RWAs as calculated by the standardised approach. For CRTs to achieve the required reduction of RWAs as calculated by the standardised approach, the simplified supervisory framework approach (SSFA) must be used and this requires thicker tranches.

Hedging IRB assets, however, generally means the use of the supervisory framework approach (SFA), which delivers the same capital relief on thinner tranches. So the JPMorgan deals incorporated tranches in the region of 0%-12% or 0%-13%, whereas in Europe – where IRB modelling is common and there is no Collins floor – tranches are more generally in the region of 0%-7% or 0%-8%.

Lawyers agree that the tide is turning in the US and the increasing disparity between RWAs calculated by IRB models and by the standardised approach is one of the influences bearing down upon issuers and potential issuers. "I'm hearing banks are more interested in this, which suggests they want to reduce capital associated with higher quality assets. If the standardised approach is the binding constraint, then by definition you're holding too much capital against higher quality assets because the standardised approach does not differentiate based on credit quality of exposures," says Carol Hitselberger, a partner at Mayer Brown.

There are other reasons for doing CRT trades, aside from regulatory capital relief. Citi is the pioneer of this market and it says that the risk relief is every bit as important as regulatory capital relief.

Figure 1: Evolution of the balance sheet



Source: JP Morgan Chase & Co

Citi has a very large emerging markets lending book. Only HSBC rivals it in terms of global footprint. And it has been using CRT since 2007 to reduce counterparty exposure, a significant number of which are not investment grade names.

The bank completes perhaps five or six trades a year, all of which are either bilateral transactions or with a couple of investors. They are not syndicated or broadly distributed and largely occur below the radar screen.

The advantage of this approach is that Citi does not have to divulge details about its lending book, its loan history and how it originates loans, all of which is sensitive information but all of which would have to come to light if it did capital markets trades. Moreover, amending the payment terms or maturity of a transaction is considerably easier if dealing with only one investor.

Carol Hitselberger, Mayer Brown

While not every US bank possesses the sort of diverse loan book Citi does, the use of CRT mechanisms to reduce economic risk is clearly germane. It provides a template for others to follow.

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The bank agrees that the economic capital benefits are as important as the regulatory capital relief benefits. "Citi likes doing these deals for economic capital reasons as well. It's absolutely essential we can look our regulator in the eye and say, 'We're not arbing this. This is real risk transfer; we are doing this to free up capacity to do more lending and an important side benefit is RWA relief'," says Renault.

The fact that the major names in the banking world, like JPMorgan and Goldman Sachs, have initiated CRT transactions in the last year or so is also expected to allay some of the apprehensions and misgivings smaller banks might have felt about taking to the waters. "The Goldman Sachs and JPMorgan deals show the regulatory framework is in place. The regulators gave their stamp of approval and other banks will be looking. The fact that JPMorgan and Goldman are doing it makes a difference," says Lanson.

Hitselberger agrees that there has been a sea change in the last 12 months. "JPMorgan is doing high-profile deals; other banks are doing bilateral non-capital markets deals. So I think there is more appetite out there."

She continues: "We're getting calls about it literally every day. We've got investors talking to us as well. Everybody is pitching it to each other."

Ironically, the disparity between IRB models and the standardised approach shifted once more last year as volatility shot up and banks downgraded a large portion of their loan books as a result of the Covid-19 market dislocation. One major US commercial bank reports that in 2020 it was constrained by its advanced model for the first time since 2017.

But this is not expected to be a longstanding development; rather a temporary phenomenon as a result of exceptional circumstances. In 2021, the top US banks are expected to be constrained by the Collins floor once more as IRB RWAs plummet.

So, the impetus for the top US banks to make more use of CRT is maintained. Renault points out that the market is already changing.

"Last year, there were 40 transactions in total, and 16% of these were US. Normally it's about 5%. Seeing the top two or three banks do deals like this might make the next tier much more comfortable," he says.

The advantages of doing CRT transactions from an RWA perspective and from an economic capital relief perspective now seem unarguable.