The iceman cometh?

The recent Merchants Bank of Indiana deal could herald a thaw in the US capital relief trades market. **Simon Boughey** investigates.

While the European significant risk transfer market has enjoyed two successive record-breaking years of issuance, the US market has been in a new ice age. While there has been the occasional deal from regional banks like Western Alliance, the rich promise offered by the Texas Capital Bank transaction two years ago has not been fulfilled *(SCI 11 March 2021)*. **However, there are signs that the US market is set for a thaw.**

The remainder of this year could see a more temperate climate in the US return, hope market-makers and investors. The first indication of the green shoots of spring was the deal brought by Merchants Bank of Indiana at the end of March. The US$158m face value deal referenced a pool of US$1.13bn healthcare real estate loans, paid SOFR plus 15.5% and attached at 1% of losses.

The advisor was Atlas SP Partners, a new standalone ABS financing firm spun out of Credit Suisse's securitised products group *(SCI 9 February)*, while Computershare provides securities administration.

There were four investors, say sources, but their identity is not known.

There are several noteworthy features about this capital relief trade. First, it was executed at a time of maximum stress for US regional banks. Signature Bank and Silicon Valley Bank had just gone under, and stock market valuations for several other regionals plummeted.

That any US regional bank could bring a CRT deal at a time like this is noteworthy, but that Merchants Bank of Indiana could bring a deal is even more eye-catching. It is a small bank: its market capitalisation is just over US$1bn and it has net assets of less than US$11bn. It is only the third largest bank in the state of Indiana.

This particular CRT also referenced a pool which comprised about 10% of its entire asset worth with a chunky first loss piece.

"If an US$11bn bank can bring a deal with a US$1.1bn reference pool and a US$157m first loss piece, that brings a lot of attention," comments a senior treasury banker with a US regional.

Third, and perhaps most compellingly, the assets referenced are not only unusual in the US CRT market, but they are also risky. The deal references bridge-to-HUD (Department of Housing and Urban Development) financing for commercial real estate healthcare loans, both of which aspects should give any investor pause for thought. ▶

Terry Lanson, Seer Capital

The HUD loans might be stalled, and the commercial real estate healthcare sector is one of the more worrisome areas of US lending. "I've looked at the portfolio and there are some genuinely hairy loans in there," says one asset manager.

Previous US regional bank deals have generally referenced mortgage lending, or mortgage warehouse lending, both of which are considered low risk even though they carry a 100% risk weighting under standardised treatment.

"A lot of recent deals in the US were backed by mortgage warehouse or capital call assets, which are thought to have very low credit risk. Healthcare bridge-to-HUD loans are significantly riskier, so investors in the Merchants deal assumed much more credit risk on the reference portfolio," says Terry Lanson, an md at Seer Capital in New York.

Yet, despite all these red flags, four investors were lined up and took the risk. They were rewarded with a thick tranche of 1%-15% and a yield of SOFR plus 15.5% – several hundred basis points in excess of what is more common in Europe at the moment.

But the buyers were prepared to do the work and investigate the risk on offer before signing the cheques.

All these are not signs of a market on its sick bed.

Merchants Bank of Indiana, which was unavailable for comment, is also reputed to have executed a bridge-to-HUD multifamily loan CRT deal in 2022, so it is fair to say that it is specialising in bridge-to-HUD deals. Those two deals were worth a total of between US$2bn and US$3bn, which is hefty for an US$11bn bank.

One of the deterrents to greater regional bank use of the significant risk transfer mechanism is that they are too complex. It takes a long time for the treasury management team to figure them out, and when they do, then the board still can't understand it. Not so, evidently, US$11bn Merchant Bank of Indiana.

There are other positive signs in the wind. One, perversely, is the concern over US regional banks.

"I would say a good half-dozen banks are dead banks walking. A lot of banks are saying they are confident about credit. As soon as I hear banks saying they are confident with credit, I get anxious," says a regional bank source.

Consequently, it behoves all banks that are left standing to make their balance sheets look as good as possible. "Any regional bank in the US today is looking at any and all solutions to improve capital ratios and improve risk," says Lanson.

suitable candidate for new deals if investors are prepared to do their homework.

"There are a lot of opportunities in commercial real estate. Deals will be maturing, and if banks refinance, they will have to do so at much higher rates. Some of these office properties are now only 40% occupied, with working-from-home. Can bank balance sheets handle this?" asks the regional treasury banker.

While by no means as risky, capital call – or subscription – facilities have also been added to the roster of eligible assets over the last year. Western Alliance brought a synthetic securitisation of capital call loans in July of last year, with Blackstone the buyer, and is rumoured to have done another with an insurance firm on the other side.

Law firms that deal with putative borrowers agree that the roster of potential asset classes to be securitised is growing. "Most of the new interest we see coming in is for the specialised assets like Merchants Bank did. We see interest in subscriptions credit facilities and NAV facilities; we're seeing a lot of interest in multifamily housing loans. If the capital relief is high and right now these loans have a low rate in a rising rate environment, so you want to move the risk off the books as soon as possible," says Matt Bisanz, a partner in Mayer Brown's financial services regulatory & enforcement practice.

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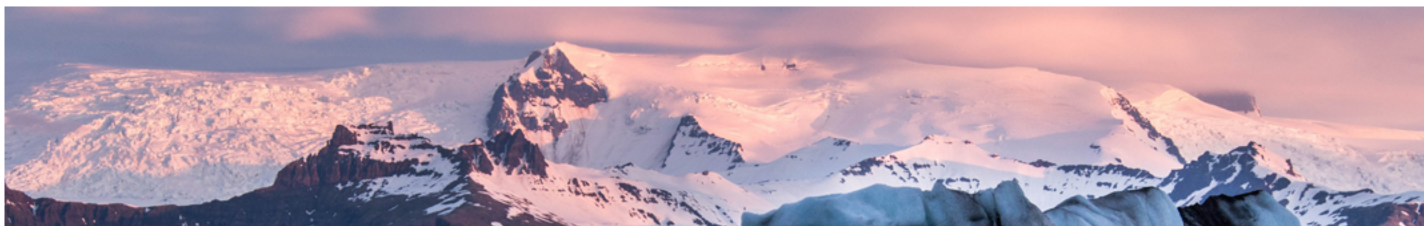
Nor should regionals expect any help from Washington. The recent bank failures have been cited as an example of regulatory failure, and the response from regulators is likely to be more onerous oversight rather than less – particularly given that the current regimes at the agencies, such as the SEC and CFTC, are in favour of greater intercession rather than less.

All regional banks are governed by standardised treatment of risk weighted assets (RWAs) and none are big enough to be allowed to use internal risk-based (IRBs) models – and that isn't going to change any time soon either. Standardised treatment is something of a blunt instrument, assessing loans of varying credit risk at 100%, with no exceptions.

So, regionals must sort out the answers on their own. The CRE sector is thought an especially

There is a caveat to be made about the Merchants Bank trade. While it was certainly executed after the collapse of Signature and SVB, all the moving parts had been put in place a long time before that. The investors had had weeks to examine and get comfortable with the risk, so weren't going to get spooked by a couple of unrelated banks going belly up.

It would also be a mistake to think that a lot of banks of around the same size as Merchants Bank are now knocking at the door. The truth remains



that most of the smaller banks still don't know much about SRT. But, by extension, this also means that the US regional market represents a vast new continent to be explored.

"A lot of regional banks don't yet know of the opportunity in this space. When you get down to the US$50bn asset value and below, there is still a huge untapped market in banks that are familiar with it," says Bisanz.

Of course, one of the main reasons why there is the possibility of greater business in the regional market is that smaller banks are regulated differently and less onerously than the major tier one institutions. An estimated 20 banks or more with asset values of about US$100bn are interested in bringing deals but are held back by regulatory uncertainty. And there hasn't been a deal in the tier one market since December 2021, whereupon the Federal Reserve Board applied the brakes to the whole process.

The Fed was not comfortable, or fairly abruptly decided it was not comfortable, with the CLN structure that had been de rigueur among the major US banks – such as Citi and JPMorgan – until this time. Sources suggest the sudden wave of SRT deals from US banks in 2020 and then 2021 alarmed the regulators and they decided to have a look at the market before granting capital relief to any new trade. This effectively shut down the market.

Regulatory distaste for the product appears to many to be unjustified. "US deals have always been super clean. There are no bells and whistles. There are no time calls, as in Europe, which are sometimes controversial. There is no synthetic excess spread. All tranches are first loss, and the cash is always with the bank as the market migrated to CLNs. What is there not to like from a regulatory standpoint?" says Olivier Renault, portfolio manager and head of risk sharing strategy at Pemberton Asset Management.

Olivier Renault, Pemberton Asset Management

It is not clear on what grounds the Fed objects to SRT. It is thought that it feels SRT runs afoul of reservation of authority clauses in Regulation Q, but to what extent and why is less certain.

The inherent fungibility of cash is reckoned by some to lie at the heart of the Fed's qualms. In the case of a CLN, the borrower retains the cash derived from the deal and then lends it on. It is not ring-fenced, and perhaps this set the cat among the pigeons at the Fed.

"ALL TRANCHES ARE FIRST LOSS, AND THE CASH IS ALWAYS WITH THE BANK AS THE MARKET MIGRATED TO CLNS"

"When you give a bank US$100 and the bank returns it, you get any US$100 because the original US$100 can't be identified. A bond can be identified by a CUSIP, but cash can't be identified," says a portfolio manager with an asset manager in London.

The matter has been complicated by personnel changes at the Fed. Sources say that a key figure in supervision left the regulator in 2021 and it took six months to find a replacement. When a suitable candidate was found, there were other more pressing requirements that needed attention, so the SRT market appeared to slip to the bottom of the to-do list.

In consequence, it seems that the banks are going back to the structures with which the Fed has no issue, which are the use of an SPV, financial guarantees or direct CDS transactions. None of these are ideal for banks, however.

The use of an SPV presents logistic complications, but also could require supervision by the Commodity Futures and Trading Commission (CFTC) as a commodity pool operator and compliance with derivatives rules. Banks have sought to avoid this. There is also the danger that the use of an SPV will contravene the so-called Volcker Rule, which forbids proprietary trading.

The financial guarantee option, meanwhile, presents a whole host of unwelcome tax consequences if the assets are based in the US – which is usually the case.

Use of credit default swaps run the banks into the meshes of the Financial Standards Accounting Board (FASB) Rule 153, whereby the CDS would have to be marked to market but the assets being securitised receive accrual accounting. This subjects the earnings statement to all sorts of unhappy volatilities, which look bad to shareholders and banks always try to avoid.

As such, banks in the US seem to be between a rock and a hard place. The latest well-founded rumours suggest JPMorgan is going back to the SPV model and will close a deal in Q3.

The bank has been one of the most outspoken critics of the current capital regime, and with good reason. Its CET1 ratio has increased to a whopping 13.8% after a boost in corporate lending in Q1.

If regulators won't find a way through the impasse, then the banks must do so themselves. It is also bewildering that the Fed seems intent to make it as difficult as possible for banks to hedge risk in a period when economic headwinds are strengthening.

"Some banks in the US will struggle to raise capital any time soon, especially the second-tier names. It will be incredibly expensive to do sub debt. Do they really want to shoot a way for them to genuinely hedge risk? These are real risk transfer deals, not smoke and mirrors," concludes Renault.

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