Risk transfer boost

US CRT activity has picked up this year, with banks seeking to manage higher capital requirements. **Stelios Papadopoulos** examines the adoption of the technology across the pond.

The US capital relief trades market has witnessed a boost in issuance this year following transactions by Goldman Sachs and JPMorgan (*SCI passim*), as US banks attempt to manage higher capital requirements amid a rise in loan loss provisions due to the coronavirus crisis. However, although US lenders will likely utilise the technology as an additional tool for managing capital, they are not expected to rely on it as much as European banks.

JPMorgan opened the US CRT market in October 2019 with a residential mortgage transaction dubbed Chase Reference Mortgage Notes 2019-CL1. US banks have tried to execute trades in the past, but rendering that first move became a problem four years ago when the OCC reportedly refused to authorise a previous JPMorgan CRT.

Nevertheless, after the supervisor gave its blessing to the Chase deal in February, other transactions followed (*SCI 3 March*). So far this year, JPMorgan has brought further residential mortgage and auto loan portfolios to market, while Goldman Sachs followed suit in September with a corporate transaction (*see SCI's capital relief trades database*).

However, although a noticeable increase in activity has been observed, the motivations for executing US deals appear less clear from a cost of capital perspective. First, the trades are backed by assets – such as mortgages and investment grade corporate revolvers – where the risk weights are already low.

The European experience with mortgages is a case in point. The lowest risk weight available in the securitisation regime under the CRR is typically higher than mortgage risk weights, so capital relief is generally not available at an acceptable cost of capital if that is the primary motivation. Banks therefore would normally aim for accounting derecognition through the sale of a mortgage portfolio, when seeking to manage capital or leverage.

SCI data demonstrates this scenario, given that the bulk of recorded transactions have been in the corporate and SME space, where substantial capital savings can be made. European banks that have carried out mortgage deals in the past did so for other reasons, such as the management of internal risk limits (*SCI 25 July 2019*).

Second, US transactions feature much thicker tranches, compared to their European cousins. Consequently, at first sight, it appears that banks are paying hefty premiums for receiving little in the way of capital relief.

The answer to the puzzle lies in the thicker tranche requirements of US regulations, where typical thickness ranges from 0%-12.5%. Carol Hitselberger, partner at Mayer Brown, explains: "The 12.5% thickness is the breakpoint under the standardised approach for getting the retained ▶

Carol Hitselberger, Mayer Brown

> "THE 12.5% THICKNESS IS THE BREAKPOINT UNDER THE STANDARDISED APPROACH FOR GETTING THE RETAINED SENIOR EXPOSURE OF THE BANK TO THE 20% RISK WEIGHT FLOOR"

senior exposure of the bank to the 20% risk weight floor. Under the standardised approach, banks typically apply 100% risk weights for their entire book, regardless of the quality of underlying exposures. Europe is more risk sensitive, such as the US advanced approach."

Similarly, an investor notes: "The regulation is applied differently in the US. The large US banks are constrained by the standardised approach, given the use of the standardised approach floor when calculating their capital requirements. European banks, on the other hand, are still waiting for the Basel 4 floor to kick in before they get the same capital treatment."

The Basel Committee advocated using the standardised approach to calculating risk-weighted assets (RWAs) in the form of a floor for the outputs of internal models. Eventually, in December 2017, the committee agreed to set the floor at 72.5%.

The latter was a compromise between US regulators – who argued for a higher level – and European supervisors, who wanted a lower one. Nevertheless, as a result of the Collins amendment to the Dodd-Frank act, the US has already adopted the standardised approach as a binding constraint even for most banks subject to advanced approaches.

However, this is where the most salient differences between the two jurisdictions end. In fact, the US market shares several features with European CRTs, especially when it comes to corporate revolvers.

Kaelyn Abrell, partner and portfolio manager at ArrowMark Partners, states: "With the Covid situation, we have seen revolver portfolios attracting higher capital requirements through a combination of revolver draw-downs and borrower downgrades and hence banks have had additional incentives to issue in order to manage increased capital requirements. Despite higher costs compared to pre-Covid periods, CRT remains the most cost-efficient way to manage risk and capital for revolver portfolios. Most revolvers are typically 10%-20% drawn in normal times, so they are for the most part unfunded."

Another similarity is disclosure. Abrell comments: "We don't see a clear difference here between US and European banks. When securitising syndicated revolvers -which have few disclosure restrictions, especially in the US – banks usually opt for disclosed pools because they allow investors to perform their own analysis and leads to better execution and lower coupon spreads."

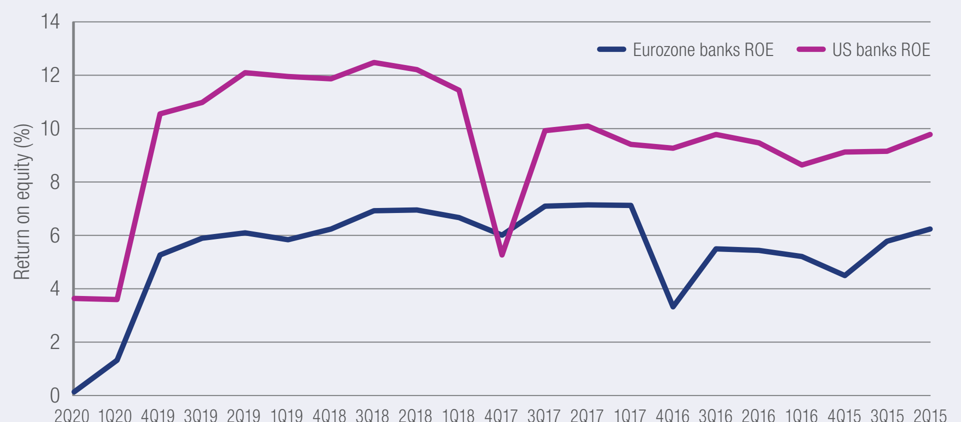
She continues: "However, when portfolios include more term loans and/or bilateral transactions, then banks may opt for non-disclosed pools to address confidentiality concerns. But for this to be securitisable, the bank would need to have a very diversified portfolio at the borrower level. We have seen both types of transactions in 2020 in both Europe and the US."

Finally, ratings – when necessary – have been another common theme. Abrell remarks: "US banks are not required to get a rating for mezzanine tranches – although when issuing thicker tranches, banks often opt to re-tranche into a junior and a mezzanine tranche, aiming for better execution by attracting different types of investors. Some investors in mezzanine tranches, such as insurers, get a benefit in terms of their own capital treatment from having external ratings on the tranches. Again, this is a theme we see both in the US and in Europe."

One key question is whether the pick-up that has been observed in the US market is sustainable or temporary, due to Covid-driven loss provisions. Following the economic downturn, US banks doubled their allowances for loan losses on the back of about US$115bn of provisions for 1Q20 and S&P believes that higher provisioning should be expected. The rating agency's base case

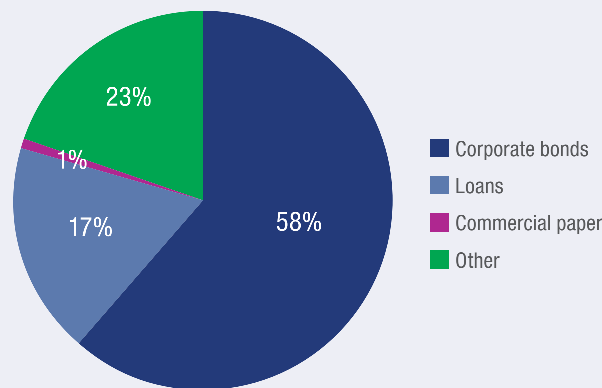
Kaelyn Abrell, ArrowMark Partners

Figure 1: Return on equity – US and Eurozone banks 2015-2020



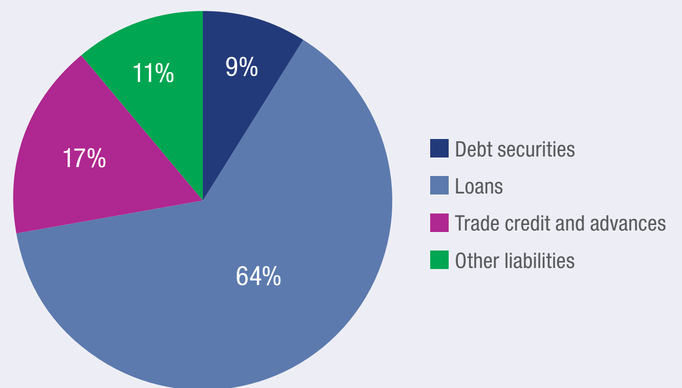
Source: ECB, FDIC

Figure 2: US non-financial corporate debt 2Q20



Source: Federal Reserve

Figure 3: Eurozone non-financial corporate debt 2Q20



Source: ECB

projection is that the pandemic will trigger 3% loan losses, forcing banks to provision more than US$330bn cumulatively.

Yet performance will vary significantly from bank to bank, depending not only on the quality of their underwriting and loan losses, but also on the sufficiency of their Q2 allowances and on their ability to absorb losses through pre-provision net revenue (PPNR). Larger US banks generally have more aggressively built their allowances and have stronger PPNR than regional and smaller banks and are less likely to have bottom-line losses, should loan losses approach S&P's base-case estimate for the industry.

md and head of North American banks at Fitch: "Large US banks tend to be more profitable for a number of reasons, such as the fact that they have larger and more profitable high interest credit card portfolios on their books. However, this is less true when looking at smaller banks of less than US$10bn in assets."

Monsur Hussain, head of financial research at Fitch, adds: "Higher profitability means that you have to pull fewer levers from a balance sheet perspective, since you can generate capital organically. Nevertheless, Basel 4 and CECL will require some equity hedging, so there is a clear role for synthetic securitisations in the US."

> "HIGHER PROFITABILITY MEANS THAT YOU HAVE TO PULL FEWER LEVERS FROM A BALANCE SHEET PERSPECTIVE"

Indeed, the high profitability levels of large US banks where US CRT activity is concentrated means that US issuance will likely remain subdued relative to Europe. The investor comments: "US banks have higher returns on equity, relative to European banks, better net interest margins and a flexible cost basis. EU banks, on the other hand, are more fragmented and operate in a more competitive market which has seen less consolidation and lower returns on equity – all of which are further exacerbated by negative interest rates."

The loans on US bank balance sheets is one reason behind the discrepancy between the two jurisdictions. According to Christopher Wolfe,

Legacy issues pertaining to business models and non-performing loans are another driver. Christian Scarafia, senior director at Fitch, notes: "European banks have suffered from negative interest rates and some had to readjust business models, although this has varied across jurisdictions. Domestic retail banking is profitable in several countries, including in the UK, while in some countries – including France – the large banks have benefited from diversified business models."

He continues: "However, If you look at retail banking in Germany, the savings and cooperative banks benefit from strong franchises, which has made it difficult for other banks in the sector to gain from a profitable home market due to competition. Furthermore, banks in some southern European countries had to deal with large volumes of legacy NPLs."

Moreover, the relative size of European bank balance sheets is larger, with European firms relying much more on bank lending versus their US counterparts. US banks hold US$21.1trn in total assets, but European banks have scaled that up to €26trn as of 2Q20, according to FDIC and EBA data respectively. Hence, managing risk weighted assets is a more pressing need for the latter than the former.

Terry Lanson, md at Seer Capital, explains: "A key difference between the financial systems in the US and Europe is that a wider range of US firms have access to the capital markets. European banks, on the other hand, hold large volumes of exposures to mid-caps and SMEs which cannot access these markets. Overall, bank balance sheets in Europe are larger as a share of GDP and they must be more creative in managing their risk weighted assets."

Looking forward, he concludes: "The US has also recovered more strongly since the 2008 financial crisis than most European countries, leaving European banks more challenged in terms of returns and capital ratios. So, we don't foresee US banks relying on SRT to the extent that European banks do, but SRT will be an additional tool for managing capital and risk."

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