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How banks can use CRTs to optimize their balance sheets

CRTs are not new but are growing in the United States

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Introduction

Credit risk transfers (CRTs) are a growing financial transaction among US banks. Global bank issuance of CRTs surpassed \$16.6 billion in the first nine months of 2024, and was on pace to reach an estimated \$30 billion at year-end, although actual figures may be higher because some transactions are not publicly reported.

The market for CRTs is expected to grow as US banks are expected to increasingly use CRTs to reduce hundreds of billions of dollars' worth of credit risk exposure over the next few years.¹

By contrast, in Europe, where these transactions are called "significant risk transfers" (SRTs), as analyzed in Gonzalez and Triandafil (2023), these transactions have "reached sufficient critical mass to make SRT a permanent feature in European banks' capital management toolkit."² So it may not be surprising that a majority of the global issuance still originates in Europe.

This overview will address some of the questions US bank executives may be considering, such as the mechanics of a CRT transaction and the US regulatory stance that may influence their choices.

What are CRTs?

As the name suggests, CRTs are financial transactions that allow banks to transfer credit risk to a third party. Unlike other forms of risk transfer, CRTs allow banks to maintain the lending relationship with the client. Implementation of a CRT should reduce credit risk, lower regulatory capital, and, if properly priced, increase return on equity.³ In fact, CRTs appear to be part of a trend in which banks adopt a more capital-light strategy by optimizing their balance sheets to share risk with nonbanks, such as credit funds.⁴

Banks have relied on other financial transactions such as portfolio sales or credit default swaps (CDS) to reduce risk. Often, banks sell a portfolio of loans to an investor but may retain servicing. For CDS, the collateral remains on the balance sheet, and the transaction acts as insurance if the borrower defaults. CDS are often bespoke and generally mark-to-market. In a CRT transaction, a bank transfers a portion of a loan portfolio's credit risk to a third party. Unlike selling the portfolio entirely and taking it off the balance sheet, with a CRT the loans usually remain on the balance sheet and are used as a reference while all or some of the credit risk is transferred to a third party that receives payments in return. Because the loans remain on the bank's balance sheet, these transactions are also called "synthetic" and can result in the avoidance of loss recognition on collateral priced below the current market, which would occur on the sale of collateral to a securitization. In the United States, these transactions are usually done using credit-linked notes (CLNs) so the riskier (i.e., junior) loans' credit risk can be transferred to investors.



How do CRT transactions work?

Figure 1 shows how a simplified reference loan pool is divided in a CRT transaction. In a typical transaction, the bank retains the most senior tranche that is furthest removed from the expected losses attributable to underperforming collateral (i.e., the greatest subordination cushion). A bank may also choose to retain the first loss position depending on the overall cost and capital benefit of the transaction. The mezzanine tranche (i.e., a middle tranche) is sold to investors. Descriptions of the tranches follow:

- The **first loss** represents the expected losses of the portfolio. The bank calculates the first loss based on historical loan performance, expectations of defaults, and collateral-specific recoveries, as well as the lag to recovery.
- The **mezzanine tranche** is the portion that usually represents unexpected losses. The investors will receive payments from the loan pool based on its performance.
- The **senior tranche** is retained by the bank and is structured to experience the portfolio's remotest possible losses and represents the most significant percentage of the capital structure. Given the subordination provided by the first loss and mezzanine tranches, the senior tranche is not typically expected to experience defaults.

See Appendix for a numerical example.



Figure 1. Overview of a credit risk transfer

Source: Adapted from ESRB⁵

There are two main methodologies for credit risk transfers—funded or unfunded:

- In a **funded transaction**, the investor purchases notes (i.e., collateral) through an intermediary; for example, a special purpose vehicle (SPV). These transactions usually use CLNs to distribute payments, which lose value if the collateral underperforms and eats through the subordination.
- In an unfunded transaction, no collateral is provided, and the investor provides money when the tranche underperforms. As a result, banks are exposed to counterparty risk if an investor does not provide the funds and therefore the bank is required to hold capital against this risk. For this reason, banks may expect greater scrutiny to get capital relief and, therefore, unfunded transactions may be less common.

A third methodology involves **non-payment insurance** (NPI). An insurer will protect against default on the exposure on a pro rata basis (not usually tranched) to cover unexpected losses. These are typically used for single loans and less diversified portfolios, such as project finance.

Below are four different types of CRT transactions: funded securitization with SPV, funded synthetic securitization, unfunded synthetic securitization, and non-payment insurance.⁶ Note: These are just some of the variations of CRT transactions, not all.

Figure 2. Funded securitization with SPV



Source: Adapted from ESRB7

In this transaction, the entire portfolio goes into the SPV. The SPV issues all notes that are distributed, some to external investors and some to the bank. The mix depends on the transaction.

The investor fully funds the transactions with collateral, e.g., cash or securities.

As the loan performs, loan payments are passed to the SPV and then to the investor. If the loan underperforms, the collateral from the SPV is transferred to the bank.

The SPV is under the custodianship of a trustee.

Figure 3. Funded synthetic securitization



Source: Adapted from ESRB⁸

Figure 4. Unfunded synthetic securitization



In this transaction, all tranches are retained on the balance sheet. A CDS is taken out on the mezzanine tranche, i.e., a synthetic transaction.

The transaction could be arranged as an unfunded CRT or a cash-funded CDS, which is bespoke and references a specific static pool of loans.

As the loan performs, loan payments are paid to the investor. However, if the loan underperforms, the investor sends payments to the bank.

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Source: Adapted from ESRB⁹

Figure 5. Non-payment insurance



Source: Adapted from ESRB9

What are the regulatory rules for CRTs in the United States?

The US regulatory rules are still uncertain because there have been no official guidelines. This may change if the Federal Reserve provides more guidance as the CRT market grows.

In September 2023, the Federal Reserve released frequently asked questions (FAQs) addressing CRTs, specifically the use of CLNs.¹⁰ As noted on the Federal Reserve website, these are not recommendations approved by the Board of Governors (Board) but rather staff interpretations. Since regulators have previously recognized the use of credit risk mitigation strategies, there is already a framework for applying similar principles to CRTs.

The FAQs explained how the Board may view two different types of CRTs: 1) a bank uses an SPV and 2) a bank issues CLNs. For securitizations through an SPV, a bank can recognize the mitigation effects because it meets the Regulation Q definition of synthetic securitization; whereas for bank CLNs, the FAQs address whether it meets the definition of synthetic securitization and explain this type of transaction must:

- Include a guarantee or credit derivative.
- Use a recognized risk mitigant, such as collateral, to be classified under the simplified supervisory formula approach.

The Board staff response on how to address CRT structure goes on to clarify that even if the bank CLN is directly issued in a cash transaction (i.e., fully funded), the cash is owned by the note issuer (i.e., bank) and therefore is not a collateral interest. As a result, the CLNs reviewed by the Board staff "do not satisfy the definition of synthetic securitization and generally do not satisfy the operational requirements of the SSFA." However, the FAQ states the Board may recognize the capital relief from bank CLNs where it differs on these two issues.

Banks should be cautious as regulators have the final determination over whether to approve the capital relief of the CRT. Given CRTs increase a bank's leverage ratio, regulatory approval may continue to be required. At an open Board meeting in July 2023, Federal Reserve Governor Michelle Bowman stated, "Capital rules should give greater recognition to bona fide transfers of risk that achieve the same economic outcome as a permitted risk transfer under the [proposed] rules."¹¹

What might investors be looking for in CRTs?

Investors, such as credit fund managers, may be looking for a granular understanding of how the bank operates to determine whether the CRT is priced for the underlying risk of the loans. Because CRTs are bespoke deals, investors need to understand the details of the loan pool being transferred, such as the asset class and replenishment criteria of the CRT. In effect, the investor is underwriting the bank's underwriting capabilities.

Investors and banks that issue CRTs are taking advantage of standardized risk weights set across the banking system, which do not reflect the risk for an individual bank's portfolio. For example, if a bank has a high-quality auto loan portfolio, it still needs to maintain risk weights set by the capital rules that are also followed by a bank with lower-quality auto loans. The bank with high-quality loans can offload its lower-risk loans to a willing investor who wants to own the credit risk. Therefore, banks with high-quality portfolios may benefit the most from a CRT because the highest-quality assets are often the lowest-yielding assets. Furthermore, CRTs permit the bank to earn new origination fees from recycling capital.

CRTs are further evidence of banks finding more capital-light strategies

The CRT market appears to be in an early growth stage in the United States. Banks should consider how this market benefits their capital optimization strategy and when and how to enter it. A successful CRT strategy can have multiple benefits, including lowering credit risk and boosting return on equity.

Furthermore, it is an example of how banks are adapting to the growth of third-party investors, such as private credit funds. CRTs are a potential synergy between the two industries, as banks act as intermediaries for funds looking to deploy capital, akin to the rising popularity of origination partnerships between the two industries.



Appendix

A hypothetical bank has \$1 billion in auto loans. The bank plans to engage in a credit risk transfer, retaining the first loss and senior tranche, while transferring the mezzanine tranche risk.

Assume the risk weight for the auto loans is 100% and the capital requirement is 8% of the risk-weighted assets (RWA).

Additionally, assume the first loss tranche has a risk weight of 1250% and the senior tranche has a lower risk weight of 20%.



With the credit risk transfer, the bank could save \$17.2 million in capital. In effect, the bank has reduced its risk-weighted assets, which could be used to support additional lending. When banks have greater return opportunities from using the money saved from a CRT, it will likely be economical to do so.

Endnotes

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