STRUCTURED
FINANCE
ASSOCIATION

Credit Risk Transfers (CRT) Transactions White Paper

Overview of Current Structures and Regulatory Issues in CRT

First Edition | February 21, 2020

Table of Contents

STRUCTURED FINANCE ASSOCIATION

Credit Risk Transfer White Paper

What are Credit Risk Transfer Transactions?

Credit Risk Transfer (CRT) transactions are structures that involve the transfer of credit risk of all or a tranche of a portfolio of financial assets. The protection buyer will typically own the portfolio of assets, which may be corporate loans, mortgages, or other assets. The protection seller may be a bank, an insurance or reinsurance company, a trust, or other capital markets investors seeking to take on credit risk.

What is the Purpose Behind Credit Risk Transfer Transaction?

The Basel III Capital rules, and particularly the operation of the Collins floor, are such that U.S. banks face materially higher capital charges for mortgage lending compared to other market participants, such as the Government Sponsored Entities (GSEs). Under Basel III, a bank that is bound by standardized risk weighted assets under the Collins floor is required to hold capital for high-quality residential mortgages that can be as much as 2.0-2.5x the modelled requirement under the Advanced approach. Translating those higher capital requirements to a customer rate can significantly impact the cost of a mortgage for a borrower. As a consequence, CRT is necessary to ensure competitive bank participation in the housing finance market, thereby reducing the cost of credit for homeowners. By improving banks' ability to compete for mortgage capital, increasing opportunities to decrease systemic risk through deeper credit risk distribution to broader classes of investors, a level playing field for CRT optimizes the alignment interests among housing market participants.

The Structured Finance Association supports the fundamental principle expressed by the US Treasury that "similar credit risks generally should be subject to similar credit risk capital charges across market participants…(and)…the capital treatment of securitizations and other similar transfers of mortgage credit risk to third parties is another potentially unwarranted gap between the regulatory capital requirements of banking organizations and the GSEs that merits scrutiny…"[1]

Broadening market structure and leveling the playing field in a way that deliberately deepens and diversifies the pool of potential market participants are important goals to promote continued access to mortgage credit for American homeowners—particularly in light of the stated objectives outlined in the US Treasury Housing Reform Plan.

"A driver of the GSE's growth in market share, in the period post-crisis, has been a regulatory framework that is biased in favor of GSE-supported mortgage lending—a bias that has increased following the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act…reforms will level the playing field between the GSEs and private sector competitors by simplifying the Consumer Financial Protection Bureau's (the "CFPB") qualified ("QM") rule and eliminating the QM patch, reducing unnecessary regulator impediments to responsible private-label securitization ("PLS"), and limiting certain GSE activities for which Government support is not necessary or justified."[2]

This paper explores a range of options for pool-level or portfolio credit risk transfer[3]: Cash Securitization, Corporate Debt (Credit Linked Notes), Synthetic Trust Structures, and Bilateral Credit Protection (Eligible Guarantors). For each structural alternative outlined herein, we have highlighted the key issues that need to be addressed, including certain specific regulatory changes that would allow them to be viable mechanisms for banks to achieve regulatory capital relief on their portfolios. Broadening the diversity of risk distribution tools and increasing the potential investor base will improve market structure and the dynamics of distributing risk, while at the same time ensuring better pricing for consumers seeking access to credit through all phases of the credit cycle.

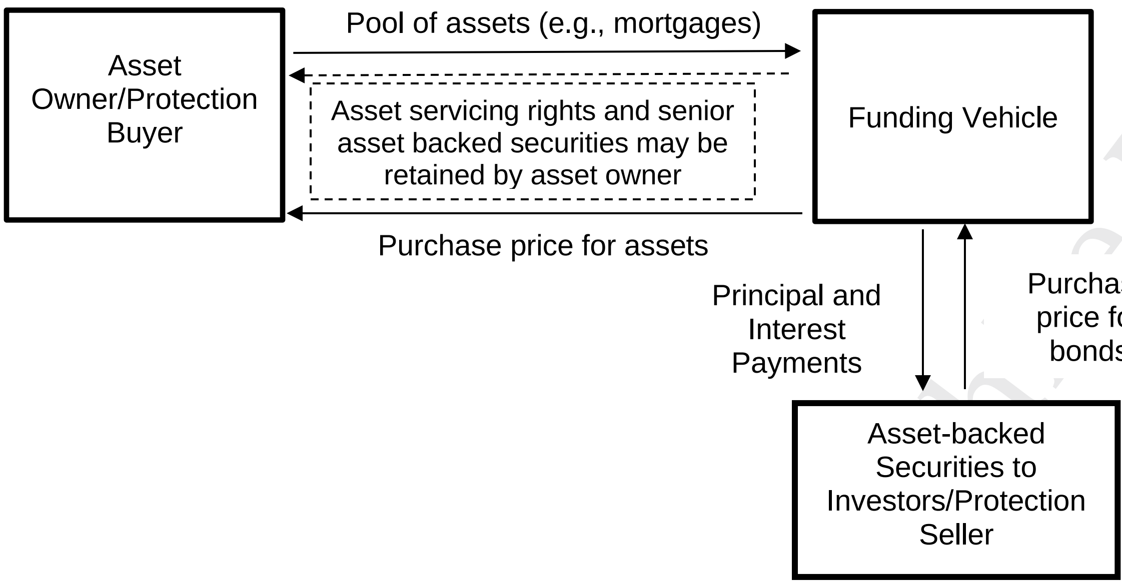
Possible Structures:

1. Structure 1: Cash Securitization
2. Structure 2: Corporate Debt
3. Structure 3: Synthetic Trust Structures
4. Structure 4: Bilateral Credit Protection

[1] U.S. Department of the Treasury Housing Reform Plan;https://home.treasury.gov/system/files/136/Treasury-Housing-Finance-Reform-Plan.pdf
2 Ibid.

[3] Note that other methods of transferring risk, including loan-level mortgage insurance, may also provide the ability to transfer risk

Credit Risk Transfer White Paper



1. Cash Securitization

The originating bank transfers a pool of assets to a funding vehicle. The funding vehicle issues asset-backed securities (ABS) to investors that represent varying levels of risk in the underlying financial assets of the funding vehicle. The owner may retain servicing rights, may purchase certain tranches of securities from the funding vehicle, and/or may otherwise retain certain economic risks and rewards from the assets. These transactions can be structured in a variety of ways, but an important feature is that the protection buyer isolates its portfolio of financial assets in a special purpose issuer.

Issues:

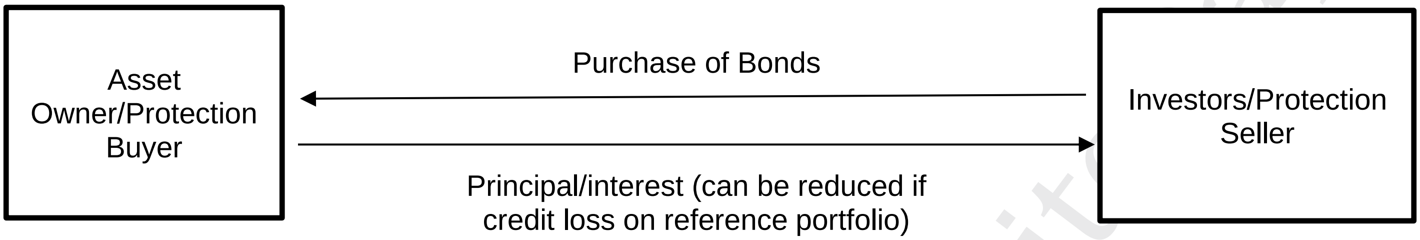
Regulatory Capital: Retention of servicing rights and a more than insignificant amount of economic risk in the ABS issued by the funding vehicle would result in the funding vehicle being consolidated by the originating bank and the transferred assets remaining on its balance sheet. The U.S. bank regulatory capital rules do not currently recognize transfers of credit risk in securitizations (other than synthetic securitizations) if the transferred assets remain on the originating bank's balance sheet[4].

Securitization Issues:

Because the assets are transferred to a funding vehicle, the regulatory requirements generally applicable to securitizations may apply, including mandatory disclosures and risk retention. For a bank that is transferring assets, this may include compliance with the FDIC Safe Harbor, so that the transfer is respected if the bank becomes insolvent[5].

4 A proposed change to the operational criteria set out in 12 CFR 217.141(a)(1) might allow either the assets not being reported on the bank's consolidated balance sheet under GAAP, or if the assets remain on the bank's consolidated balance sheet under GAAP, they are legally owned by a consolidated securitization SPE pursuant to a transaction that puts the assets beyond the reach of the bank or its creditors even in the event of bankruptcy or receivership (e.g., through ensuring legal enforceability of contracts and compliance with FDIC Safe Harbor provisions or foreign equivalent).

5 In a receivership, the FDIC retains the option to repudiate the contract and pay damages equal to par plus accrued interest on the underlying assets



2. Corporate Debt

The protection buyer (Issuer) issues a credit-linked note (CLN) directly to the investor for cash. The Issuer's obligation to pay principal and/or interest on the CLN is linked to the performance of a reference portfolio (i.e., credit losses in the reference portfolio will reduce the amounts payable to investors), effectively resulting in credit protection payments to the issuer/protection buyer. The key difference between this structure and Structure 3 (Synthetic Trust Structure) is that the principal on the CLN is not protected from the bankruptcy of the issuer/protection buyer. This structure is economically equivalent to Structure 4 (Bilateral Credit Protection) if the bilateral credit protection is fully collateralized with cash.

Issues:

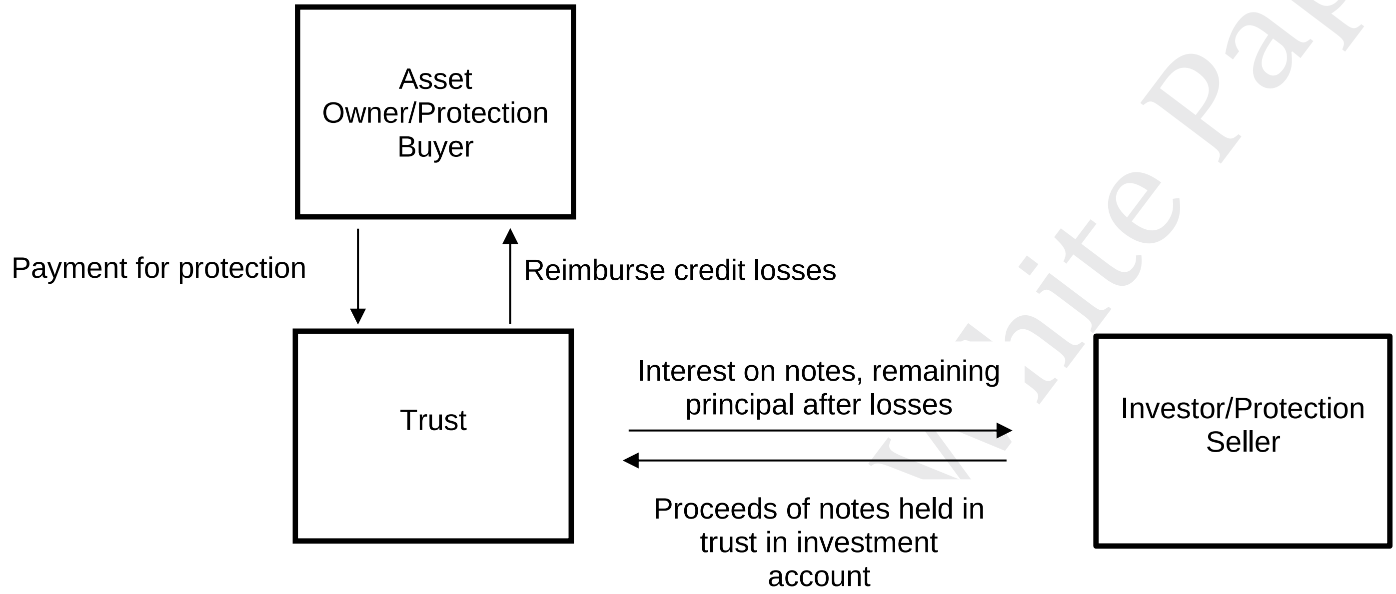
Regulatory capital: The form of the transaction and the instruments/agreements used to transfer the risk must meet certain definitional requirements. The amount of capital relief available will depend on capital framework employed (wholesale vs. securitization) and the details of the transaction.

Counterparty Credit Risk: Corporate debt exposes the investors to the counterparty credit risk of the issuer/protection buyer. Therefore, this option is only viable for highly rated protection buyers.

Accounting Issues: Misalignment of the accounting treatment of the underlying assets in the reference portfolio versus the credit protection can lead to undesirable P&L volatility. Where the credit protection is a derivative, it will be marked to market; if it is a guarantee, it will typically not be marked to market. Many protection buyers prefer to avoid hedge accounting, which results in marking the credit protection to market.

REITs: Interest on the CLNs generally will not be real-estate related income for purposes of REIT qualification tests, which dis-incentivizes them from owning the CLNs

Foreign Investors: Non-exempt investors are subject to U.S. taxes.



3. Synthetic Trust Structure

The protection buyer enters into a credit protection agreement via a credit derivative (e.g., credit default swap (CDS)) or financial guarantee provided by a trust (or other special purpose vehicle). Under the terms of the agreement the trust is obligated to reimburse the protection buyer for credit losses on a specified portfolio of assets (i.e., reference portfolio). The trust will fund its obligation by issuing credit-linked notes (CLNs) to capital markets investors. The trust's obligation to pay principal and/or interest on the CLN is linked to the performance of a reference portfolio (i.e., credit losses in the reference portfolio will reduce the amounts payable to investors). The trust is bankruptcy remote and therefore the investor(s) is protected from the bankruptcy of the protection buyer.

The ability of different institutions to participate in these kinds of transaction depends on both the relevant capital regulations as well other regulatory, accounting, and tax constraints detailed in the "Issues" section below. For instance, insurance companies can be the protection buyer via the use of insurance-linked notes.

Reference Portfolio:

The portfolio of assets covered by the credit derivative or financial guarantee is called the reference portfolio. It can be composed of loans, mortgages or other financial assets. The credit derivative or financial guarantee (called the credit protection) can cover the entire reference portfolio, a prorata portion (e.g., 10% or 20% of losses) or a tranche (i.e., stratified risk position) such as the first 60% of losses.

Issues:

Regulatory Capital: The ability for a U.S. protection buyer to recognize regulatory capital relief depends on whether the transaction has been appropriately structured in accordance with the US regulatory capital rules. The form of the transaction and the instruments/agreements used to transfer the risk must meet certain definitional requirements. The amount of capital relief available will depend on the capital framework employed (wholesale vs. securitization) and the details of the transaction.

Swap-related issues: If a credit derivative is used, the contract will potentially be subject to rules applicable to swaps or security-based swaps, which include margin and swap dealer rules. If so, swap regulations apply, which will determine whether the trust is a regulated commodity pool and affect margin requirements.

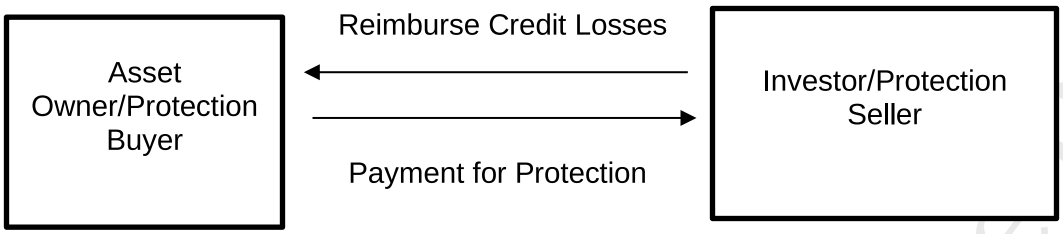
Credit Risk Transfer White Paper

Guarantee-related issues: If the credit protection is a financial guarantee (or similar instrument other than a credit derivative), there are potential insurance regulatory issues and tax issues.

Volcker Rule: If the trust is a 'covered fund' for Volcker Rule purposes, a bank or affiliate could not sponsor or take an ownership interest in the trust.

Securitization Rules: The sale of the notes will be subject to many of the rules that apply to sales of securities in securitizations

Accounting Issues: Misalignment of the accounting treatment of the underlying assets in the reference portfolio versus the credit protection can lead to undesirable P&L volatility. Where the credit protection is a derivative, it will generally be marked to market; if it is a guarantee, it will typically not be marked to market. Many protection buyers prefer to avoid hedge accounting, which results in marking the credit protection to market.



4. Bilateral Credit Protection

The protection buyer enters into an insurance contract or credit derivative to buy protection on the reference portfolio (or a tranche of the reference portfolio). The seller of the credit protection may post collateral to secure its obligation. Insurance contracts may involve a collateral account to effectively credit enhance the insurer, but the capital structure of the insurance entity, including its reserves, generally provides security for the insured/protection buyer.

Issues:

Regulatory Capital: In order for the protection buyer to get capital relief, the insurance or credit derivative must qualify as an "eligible guarantee" or "eligible credit derivative" unless the insurance/credit derivative is fully collateralized by eligible collateral. This results in the following requirements

a. Eligible Guarantor: The protection seller must be an "eligible guarantor", which means:

(i) An Eligible Guarantor may not be a monoline insurer, which potentially raises a conflict with the prevailing insurance regulations regarding mortgage guaranty that require a monoline structure.

(ii) An Eligible Guarantor must have "issued and outstanding" investment grade debt, with the Insurer Financial Strength Rating (IFSR) not being taken into account. This suggests that Eligible Guarantors must issue debt at the operating company level, which is a limiting factor for many insurers that issue debt at the holding company level

(iii) The creditworthiness of the Eligible Guarantor cannot be positively correlated with the exposure that it guarantees, which presents some limitations on Eligible Guarantors.

(iv) The creditworthiness of the Eligible Guarantor cannot be positively correlated with the risks associated with the underlying assets, which may limit Eligible Guarantors

b. Conditions for Guarantee: Among other conditions, the guarantee must be unconditional and require payment on default in a timely manner.

c. Credit for Eligible Guarantor: Broadly speaking, there are three types of Eligible Guarantors[6]. Each category of guarantor is afforded varying levels of capital relief:

(i) Sovereigns[7] and multinationals, which receive 100% credit.

(ii) Banks[8], credit unions, and thrifts, which receive 80% credit

(iii) Other entities that are eligible guarantors, which receive 0% credit.

Insurance Issues - License: If an insurance contract is used, the protection seller needs to have the appropriate license in accordance with the jurisdiction in which the transaction takes place.

6 See: 12 CFR § 628.32, inclusive of subsections

7 Limited to sovereign guarantors with CRC 0 - 1 or OECD sovereign with no CRC.

8 Limited to US banks, foreign banks with home country CRC 0 - 1 or OECD home country with no CRC.

Accounting Issues: Misalignment of the accounting treatment of the underlying assets in the reference portfolio versus the credit protection can lead to undesirable P&L volatility. Where the credit protection is a derivative, it will generally be marked to market; if it is a guarantee/insurance contract, it will not be marked to market although amounts receivable can be subject to an allowance for doubtful accounts. Many protection buyers prefer to avoid hedge accounting, which results in marking the credit protection to market.