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US DEVELOPMENTS IN THE CRT MARKET: GROWING OPPORTUNITIES

The credit-risk transfer (“**CRT**”) market in the US continues to expand, with new banks and new asset classes. Several of the largest US banks have been active in this market and have recently increased sales of risk-transfer securities tied to mortgages, corporate loans and auto loans. Most recently, the issuance of CRT notes linked to mortgage warehouse lines by two regional banks – Texas Capital and Western Alliance – has attracted significant attention and speculation on whether other regional banks will follow suit.¹ This continued development and growth of the market has market participants asking: what does the future of the CRT market look like?

The answer to this question and the future development and growth of the market depends on two factors: first, recognition of CRT for regulatory capital (“**reg cap**”) purposes in the US, and second, market familiarity and comfort with the different structures that are available. This article describes the following considerations which may affect the regulatory recognition of CRT and the expansion of the CRT market: first, the basic regulatory issues, second, the structuring considerations and third, and the legal issues that are raised. While several CRT transaction structures are possible, this article focuses on CRT notes.

Regulation of CRT transactions

The US reg cap rules that determine the impact of CRT are set out in Regulation Q², issued by the Board of Governors of the Federal Reserve System (“**Federal Reserve**”), and very similar rules issued by other federal bank regulators. The Federal Reserve’s view is critical to the growth and development of the CRT market because the Federal Reserve regulates bank holding companies, and essentially all significant banks are subsidiaries of bank holding companies. The Office of the Comptroller of the Currency, which regulates national banks, and other federal regulators are also involved in the relevant analysis.

The reg cap rules do not require banks to get regulatory approval before recognising the capital benefit of a CRT transaction. Nonetheless, most banks discuss CRT transactions with their regulators in order to get some comfort that the reg cap benefits will not be disallowed after the issuance of CRT notes.

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¹ See, for example, the Wall Street Journal article “Hot Housing Market Lets Bank Sell Mortgage Risk” July 29, 2021, <https://www.wsj.com/articles/hot-housing-market-lets-banks-sell-mortgage-risk-11627464600>.
² Federal Reserve Board, *Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks*, 12 C.F.R. Part 217 (2015) (“**Regulation Q**”).

Bank issuers get reg cap relief if a CRT transaction qualifies as a “synthetic securitisation” and meets certain other operational criteria for synthetic securitisations set under Regulation Q. In order to meet the Regulation Q definition of a “synthetic securitisation”, a CRT transaction must transfer credit risk on a reference pool of financial assets through derivatives (which are viewed by the market as including credit-linked notes) into multiple tranches. In addition, the synthetic securitisation must have a credit risk mitigant, which can include cash collateral. For CRT notes in the form of credit-linked notes, the cash proceeds of the notes are viewed as cash collateral. The rules also require that any “clean-up call” must be limited to an eligible clean-up call, which is exercisable only when 10% of the reference pool remains outstanding. Because “clean-up call” is not clearly defined under Regulation Q, this requirement has been the subject of some discussion about which discretionary calls by an issuer are permitted. In practice, CRT notes typically include a call right by the issuer if the regulators prevent the issuer from recognising the capital benefits of the notes. This mirrors the position in the European market, where regulatory calls are standard and included in most deals, in addition to the clean-up calls and, in some jurisdictions, time calls.

If the CRT transaction qualifies as an appropriate synthetic securitisation, it can achieve reg cap reduction for the issuer. The amount of the reg cap reduction will depend on the nature of the assets in the reference pool, the nature of the collateral (cash for credit-linked notes), and the attachment and detachment points for the credit protection. Typically, reg cap relief will only be achieved if the relevant collateral is subject to a collateral agreement for at least the life of the financial asset for which reg cap relief is obtained.

There is a possibility that the regulators may take a more formal, public position on the issuance of CRT notes in the future which may provide additional comfort to potential market participants, but as of yet they have not done so. There has also not been any indication to date that the Biden administration has a particular view favouring or disfavouring CRT notes.

Key structural considerations

Form of CRT

While this article focuses on CRT notes, several structures may be utilised for a CRT transaction, including CRT notes and unfunded credit derivatives swaps (“**CDS**”). In order to achieve reg cap relief, unfunded CDS needs collateral arrangements or a specialised counterparty.

All US CRT notes issued in the past year have been credit-linked notes directly issued by the bank. The terms of the credit-linked notes provide that the principal amount of the notes will be written down by credit losses suffered on the reference pool. The effect of this write-down feature is to transfer credit risk from the bank to the noteholders. These credit-linked notes are relatively simple in that they are typically unsecured obligations of the bank itself. There is usually no swap or segregated collateral. One consequence, and possible down-side, of this structure is that noteholders are exposed to the credit risk of the bank as well as credit risk on the reference pool.

Other CRT note structures are possible: for example, banks have considered establishing an SPV that could issue notes and then enter into a collateralised credit derivative or other risk transfer instrument with the bank. This SPV structure has the advantage of insulating the noteholder from the credit risk of the bank, and has for many years been a regular feature in the European market, where banks have historically used SPV structures to offer investors portfolio risk without bank risk, using either cash at bank or liquid securities with a third party custodian as collateral. However, the SPV introduces significant complexity because it requires a swap and collateral arrangements. These arrangements, in turn, cause greater regulatory complexity because the swap is potentially subject to swap regulation and the SPV is potentially subject to specialised rules (such as the Investment Company Act or commodity pool rules) applicable to SPV issuers.

Given the simplicity of the credit-linked note structure, we expect that CRT notes in the form of credit-linked notes directly issued by banks will continue to be the most frequently used structure for CRT transactions in the US markets. This mirrors the trend in the European market where a number of banks have turned, at least in part, to credit linked notes rather than SPV structures, and investors are increasingly getting comfortable with investing on this basis.

Asset pool

The reference pool underlying a US CRT transaction can be composed theoretically of any type of financial asset. In practice, the reference pool is constrained by the following limitations: the asset should have a relatively high capital cost; and the asset should have a term that is no longer than the term of a CRT that investors are willing to buy. For US transactions to date, assets have included corporate loans, fund financing, auto loans or mortgage warehouse loans. For future CRT transactions, the most attractive classes are those that combine a relatively high capital cost with relatively low default rates (such as mortgage warehouse loans), because the capital cost will maximise the capital benefit to the bank while the low default rate will make the CRT more attractive to investors. By comparison, there has in recent years been a diversification in the portfolios used in the European market, including derivatives, green financing, SME, and housing loans, and it remains to be seen whether transactions in the US market will similarly expand to include a wider range of portfolios.

An additional issue related to the asset pool is whether it is static or dynamic. A dynamic pool enables the bank issuer to put new assets in the reference pool as old assets run off. It will however require the bank to establish criteria for new assets to give reassurance to the investor about the quality of the assets in the pool. Typically, dynamic pools are structured so that there is a “replenishment period”, during which the bank can add new assets as the old ones pay off; and then an “amortisation period”, during which the CRT notes can pay down but no new assets can be added to the pool. This is the structure typically used in European deals, where the vast majority of transactions are replenishing, with either sequential or pro-rata amortisation following the replenishment period.

Risk retention

Under US law, as described further below, risk retention rules do not apply to the bank issuer. EU or UK rules may apply, however, if CRT notes are sold into those jurisdictions. As a commercial matter, some investors may require that the bank retain some portion of the reference pool on an un-hedged basis.

Legal, disclosure, and tax considerations

Not a securitisation

Credit-linked notes issued directly by banks are not viewed as “asset-backed securities” under US securities laws, because the cash flow to pay the notes comes from the bank rather than the assets in the reference pool. As a result, the credit-linked notes are not subject to US risk retention requirements or other requirements applicable to asset-backed securities.

US sales

CRT notes are generally sold to US investors in private placements. Because they are sold directly by the bank to a limited number of investors, and because they do not fit the typical risk profile of bank securities, they are typically sold under Rule 4(a)(2) of the Securities Act. The bank issuer will usually require consent by the investors for any secondary sale of the CRT Note, and this restriction supports the Rule 4(a)(2) analysis.

Swap

As discussed above, the credit-linked note structure does not involve a swap so the swap regulations will not apply. As discussed above, the SPV structure does raise swap regulatory issues, and addressing those issues will depend on the specifics of the transaction.

Disclosure

Many CRT deals do not have an offering document but instead rely on investor diligence. Such diligence will require the bank issuer to set up some form of data room for the investor to review the relevant reference pool. A full disclosure document would need to describe the reference pool and the process used by the bank to originate or select the assets, which can be challenging to prepare.

US tax

Because the CRT notes may be written down by an amount tied to the bank's losses, the CRT notes may potentially be viewed as a guarantee for US tax purposes. This characterisation causes potential tax withholding problems for CRT notes sold outside the US if the reference pool includes loans to US borrowers. There are different approaches to dealing with this tax issue which will depend on the location and default rates of the reference pool, the location of noteholders and other factors.

Conclusion: what does the future of the CRT market look like?

So long as the regulators do not take an adverse position on the issuance of CRT notes, we expect that the CRT market in the US will continue to grow. We expect that CRT notes in the form of credit-linked notes directly issued by banks will continue to be the most frequently utilised structure for CRT transactions, with new banks utilising this structure to enter into CRT transactions and expand the CRT market.

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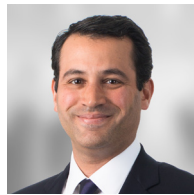


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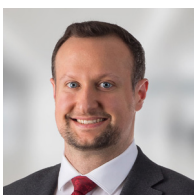
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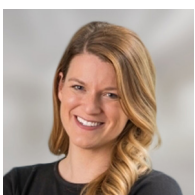
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