News

Regulatory block

US CRT sector is becalmed and regulators are to blame, say sources

US regulators have blocked regulatory capital relief trades at a time when the mechanism would be of particular value to US banks, say well-placed market sources.

So far in 2022, only Western Alliance Bank (WAB) has issued in the CRT market. Issuers that have been regular presence in the market over the past couple of years, pre-eminently Citi and JP Morgan, have done nothing and are said to be on hold.

Goldman Sachs, which issued a $3bn CLN in 2020, is also on the sidelines, though there are rumours it has something in the works for 2H 2022.

Texas Capital Bank (TCB), which got everyone excited when it became the first US regional bank to venture into the reg cap market in March 2021, has also failed to make a reappearance despite affirming at the time that the inaugural deal would be part of an ongoing programme.

It has declined to comment on why it hasn’t been seen since.

This sudden and unexpected drought in the market is due to a volte-face by regulators. The Federal Reserve Bank of New York and the Federal Reserve Board are believed to have stopped granting regulatory relief to large institutions for CRT deals in 2021.

“The market is effectively on hold among large banks due to regulatory constraints. The regulators appear to have turned course after a series of transactions in 2020-2021,” says Terry Lanson, a portfolio manager at Seer Capital - a New York-based veteran of the CRT market.

The pitiful harvest of new product in the US CRT market this year has refuted the confident predictions of expansion in the US market that were made at the end of 2021.

"We're pretty confident that the regulators stopped granting relief at the end of 2021. These are well-placed sources in the legal community that we've talked to," says another investor.

The New York Fed did not reply to a request for comment by press time.

Sources say that the regulators became disquieted by the CLN structure, as has been widely used by US issuers. Under the CLN structure, the debt is issued directly off the borrower's balance sheet, and then the notes are written down when and if the reference portfolio experiences losses.

Regulators are believed to have become concerned about the cash collateral posted by investors is not effectively on deposit, and thus cannot protect the institution should losses occur.

An SPV structure would perhaps circumvent these misgivings, but SPVs in deals of this kind come with significant shortcomings. If a large bank set up an SPV as a sponsor it may have to register as a commodity pool operator, which would create further logistic and regulatory headaches. Nor is it really feasible to ask investors in a syndicated deal to set up their own SPVs.

There is a further alternative: that regulators have developed significant concerns about the product as a whole above and beyond the cash collateral angle, so while they are prepared to approve it on a trial basis for smaller banks like WAB, approval for larger, globally systemic institutions is withheld.

"The cash collateral issue could be just an excuse for broader reservations by US regulators. However we believe these to be unfounded, as CRT has proven an effective risk and capital management tool for European banks for a long time" says Lanson.

Goldman Sachs is, of course, believed to be in the market and is hoping to do a deal later this year. Sources suggest that it could go ahead and do a deal pending regulatory approval.

It is also rumoured that while the New York Fed has set its face against reg cap deals, the Dallas Fed, which governs TCB, and the San Francisco Fed, which governs WAB, are more laissez faire.

This sudden intransigence by the regulators could not come at a worse time for US bank as they are being hit by a one-two punch combination of higher risk weighted assessments (RWAs) and higher capital ratios thanks to recent adjustments.

Firstly, RWAs derived from derivative counterparty exposures increased appreciably at the beginning of 2022 due to the adoption of the Standardized Approach for Counterparty Credit Risk (SA-CCR). This was announced in January 2020 and constitutes an extension of the standardized approach to derivatives exposure.

As the Federal Register of January 20 2020 notes, "Notably, the final rule requires an advanced approaches banking organization to use SA–CCR to determine the exposure amount of derivative contracts included in the banking organization's total leverage exposure, the denominator of the supplementary leverage ratio."

Thus, according to Lanson, "Under the SA-CCR, derivatives exposure is treated differently, so if your book of derivatives counterparty exposure would have X RWA on 12/31/2021, by 1/1/22 the RWA would have increased on the same exposure."

Even more importantly, Common Equity Tier One (CET1) ratios for US banks have leapt this year. For a large bank like JP Morgan, a CET1 ratio of 11.2% applied in 1Q 2022 but by 1Q 2023 this will have been increased by a whopping 1.3% to 12.5%.

While the base CET requirement has not been changed from 4.5%, the G-SIB surcharge increases by 50bp to 4% by 1Q 2023. On top of this, the stress capital buffer has been adjusted from 3.2% to 4% as a result of this year's Federal Reserve stress tests.

It is calculated that the top four US banks will be required to hold an additional $81bn of capital as a result of these changes. JP Morgan needs another $35.5bn, Citi a further $23.6bn, Bank of America another $18.4bn and Wells Fargo some $3.7bn.

These calculations were made by Seer Capital, based on Bloomberg data and company reports.

So, it seems that regulators have pulled out the rug from under banks just when they are in need of a soft landing.

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