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Using Synthetic Securitization In Residential Mortgage Loans

By **Brian Kuhl, Matt Bisanz and Paul Jorissen** (May 17, 2023, 5:41 PM EDT)


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In its report on Silicon Valley Bank last month, the Federal Reserve emphasized the importance of banking organizations maintaining sufficient capital positions.

In a recent transaction, Merchants Bancorp Inc. improved its capital position by completing a first-for-the-industry synthetic securitization of bridge loans on skilled nursing and senior housing facilities.

Other banking organizations that, like Merchants Bancorp, are looking to reduce the amount of risk-based regulatory capital required to support residential mortgage loan portfolios can use synthetic securitization to convert the capital treatment of their exposures from wholesale or retail exposures to securitization exposures.

In this article, we discuss how regulatory capital requirements affect banking organizations that hold portfolios of residential mortgage loans and how synthetic securitization can help mitigate the capital charge associated with these portfolios.[1]

Bank Regulatory Capital Overview

Under U.S. regulations, banking organizations must comply with minimum capital requirements intended to protect a bank's solvency. These regulations require banking organizations to maintain certain minimum amounts of capital compared to the value of the bank's exposures, which are weighted based on the level of risk associated with the type of exposure.

In general, the more liquid and less volatile an asset or exposure is, the lower its risk weight will be. Risk weights are defined in the regulatory capital requirements and reflect the regulators' assessment of the comparative risk levels of different types of assets and exposures.

When it comes to residential mortgage loans, banking organizations using the standardized approach calculate the minimum capital they are required to hold for a residential mortgage loan by multiplying the amount of the mortgage loan by its associated risk weight.[2]

The value assigned to a residential mortgage loan is generally the carrying value for that mortgage loan

under generally accepted accounting principles, or GAAP.

For a pool of residential mortgage loans, a banking organization would be required to calculate the minimum capital it must hold based on a risk weight of 100% or 50% of the value of the entire pool of loans, depending on whether the loans are qualifying first-lien exposures.

However, banking organizations may be interested in reducing the required capital by converting the pool of residential mortgage loans into a different type of exposure that is given a reduced risk weight.

For instance, the risk weight assigned to a senior securitization exposure may be as low as 20% of the value of the senior tranche — as much as an 80% reduction from the risk weight assigned to a pool of residential mortgage loans.

Banking organizations can take advantage of this significant reduction in risk-based capital requirements by converting a pool of residential mortgage loans into a senior securitization exposure through a synthetic securitization.

To illustrate in a simplified manner, a synthetic securitization of a pool of residential mortgage loans in which the bank retains a senior tranche valued at 87.5% of the unpaid principal balance of the pool and a third-party investor purchases a junior tranche valued at 12.5% can effectively transform the type of asset the banking organization holds on its balance sheet from a pool of residential mortgage loans into a securitization exposure.

This would reduce the capital the bank must hold based on the 80% difference in risk weight assigned to these two different types of assets.

Synthetic securitizations leverage existing features of the regulatory capital requirements and can be completed by almost any banking organization. But in order to realize the benefits in reducing risk-based capital requirements, a transaction needs to comply with the definition of synthetic securitization and also needs to conform with the initial and ongoing operational and due diligence requirements for synthetic securitizations.[3]

Requirements of a Synthetic Securitization

As an initial matter, in order to constitute a synthetic securitization, a transaction must meet the following requirements:

- All or a portion of the credit risk of one or more underlying exposures is retained or transferred to one or more third parties through the use of one or more credit derivatives or guarantees, other than a guarantee that transfers only the credit risk of an individual retail exposure.

- The credit risk associated with the underlying exposures has been separated into at least two tranches reflecting different levels of seniority.

- Performance of the securitization exposures depends on the performance of the underlying exposures.

- All or substantially all of the underlying exposures are financial exposures, such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities or equity securities.

In addition, banking organizations may recognize the reduction in risk weight resulting from a synthetic securitization only if the following operational requirements are satisfied:

- The credit risk mitigant is financial collateral, an eligible guarantee or an eligible credit derivative.

- The banking organization transfers credit risk associated with the underlying exposures to one or more third parties, and the terms and conditions in the credit risk mitigant used do not include certain prohibited provisions.

- The banking organization obtains a well-reasoned opinion from legal counsel that confirms the enforceability of the credit risk mitigant.

- Any cleanup calls relating to the securitization meet certain specific requirements.

Benefits of Synthetic Securitizations Under U.S. Bank Capital Regulations

If the transaction conforms to the definition of "synthetic securitization" and the operational criteria are met, the banking organization can reduce the capital charge it is required to hold on a portfolio of residential mortgage loans.

As discussed above, portfolios of residential mortgage loans generally will be subject to a 100% or 50% risk weight. This would typically result in a very high capital charge because the banking organization must hold capital against the entire adjusted amount of the portfolio. However, if a banking organization synthetically securitizes the portfolio, it can reduce its capital charge by as much as 80%.

To illustrate, a portfolio of residential mortgage loans not subject to a synthetic securitization will be given a risk weight of 100% or 50%. A banking organization generally would be required to maintain a total capital ratio of 8% for such assets.

For a portfolio of loans valued at $1 billion, then, the banking organization could be required to maintain regulatory capital equal to $80 million, i.e., the product of 8% capital ratio multiplied by 100% risk weight multiplied by $1 billion value of the portfolio.

If the banking organization attaches that $1 billion portfolio of loans to a synthetic securitization, the regulatory capital requirement could be reduced from $80 million to $14 million. To achieve this, the banking organization would issue a junior tranche, or tranches, to a third party valued at $125 million.

The risk weight of this junior tranche could be as low as 0% if it was properly collateralized,[4] so the banking organization's required capital hold for the junior tranche would be $0. The bank would then also issue a senior tranche valued at $875 million, which the bank would retain.

Because a securitization exposure is given a risk weight of 20%, the banking organization's required capital hold for the senior tranche would be $14 million, i.e., the product of 8% capital ratio multiplied

by 20% risk weight multiplied by $875 million value of the securitization exposure.

So by attaching that $1 billion portfolio of residential mortgage loans to a synthetic securitization, the banking organization reduces its regulatory capital requirement by $66 million, from $80 million to $14 million.

Types of Synthetic Securitizations

There are three primary types of synthetic securitizations, each with its own benefits and drawbacks.

The first type is a standard credit default swap or guarantee. The primary advantage of this arrangement is that it is bilateral and relatively simple.

But the downside is that the credit default swap or guarantee is illiquid and cannot be sold or leveraged, which negatively affects the pricing. Additionally, a credit default swap or guarantee must satisfy certain additional eligibility requirements that often are difficult to satisfy as a practical matter.

A second type of synthetic securitization is credit-linked notes issued by a special purpose vehicle. A credit-linked note, or CLN, is a security with an embedded credit default swap or guarantee that permits the issuer to shift specific risk to credit investors.

In these deals, the CLNs are fully funded at issuance and the proceeds of the CLN issuance are deposited into a trust account for the benefit of the bank and the CLN investors.[5]

If the cash in the trust account is used to make credit protection payments to the bank, payments on the CLNs are also reduced. Transactions containing CLNs issued by special purpose vehicles are more common outside of the U.S.

These structures are more liquid than bilateral credit default swaps or guarantees, but may raise additional costs and legal issues when compared to CLNs issued by a bank, which is the third common transaction type.

Bank-issued CLN transactions are very similar to transactions involving CLNs issued by special purpose vehicles, except that the CLNs are unsecured debt obligations of the bank rather than limited recourse debt obligations of the special purpose vehicle.

Transactions with bank-issued CLNs are more common in the U.S. These transactions are also more liquid than bilateral credit default swaps and guarantees, but also do not raise some of the legal issues and additional costs that arise in deals involving CLNs issued by a special purpose vehicle.

Reasons to Choose Synthetic Securitization Over Cash Securitization

Synthetic securitizations offer banking organizations an easier method of receiving capital relief when compared to more traditional cash securitizations.

In a cash or traditional securitization, the bank will receive capital relief only if it is able to derecognize the risk-weighted assets transferred into the securitization under GAAP.

However, achieving GAAP derecognition may be difficult due to changes that were made to the GAAP

rules after the global financial crisis of the late 2000s.

To achieve derecognition, the assets must be considered removed from the bank's balance sheet from a GAAP accounting standpoint, which is different and a more difficult analysis than simply legally transferring the assets to a special purpose vehicle.

This is particularly true if the bank retains tranches, or control of the securitization vehicle, which is a common feature of cash securitizations.

In a synthetic securitization, on the other hand, the risk-weighted assets remain on the bank's balance sheet. Therefore, synthetic securitization allows a banking organization to achieve capital relief without any GAAP analysis of asset derecognition.

Conclusion

Banking organizations that hold residential mortgage loan portfolios on their balance sheets should consider the benefits of using a synthetic securitization transaction to convert the capital treatment of their exposures from wholesale or retail exposures to securitization exposures.

A synthetic securitization would reduce the amount of risk-based regulatory capital that the banking organization is required to hold in support of the residential mortgage loan portfolio by as much as 80%, allowing the banking organization to free up cash for other purposes.

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[1] For more discussion of synethetic securitization, see https://www.mayerbrown.com/en/perspectives-events/publications/2020/02/capital-relief-trades-structuring-considerations-for-synthetic-securitizations.

[2] Certain larger and internationally active banking organizations calculate risk-weighted assets under the advanced approach. There are relatively few of these organizations and typically the standardized approach is the more relevant analysis for determining the viability of a synthetic securitization.

[3] The calculation of the specific risk weight for a securitization exposure is a highly quantitative process that is beyond the scope of this article.

[4] It should be noted that because a synthetic securitization does not remove the underlying residential mortgage loans from the balance sheet of the banking organization, the organization would technically need to look at the regulations to determine the risk weight of the exposure the organization holds in relation to the junior tranche held by a third party. However, this is normally a zero risk weight because the exposure may be secured by financial collateral (i.e. cash on deposit). Or, for synthetic securitizations that use a credit derivative or guarantee rather than financial collateral as the risk mitigant, the risk weight associated with the exposure on the junior tranche will be based on the risk weight associated with the party providing the guarantee or credit derivative.

[5] The proceeds are then typically invested in eligible financial collateral, which generally includes cash, gold, certain investment grade securities, publicly traded equities, publicly traded bonds, and certain shares of money market funds in which the banking institution has a perfected, first-priority security interest or the legal equivalent thereof.