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The Bad, the Good and the Ugly

by Neal J. Wilson

Executive Summary:

- In the years after the 2008-2009 Global Financial Crisis, banks have had to meet the regulatory challenge of increasing capital buffers against potential losses.
- Given suppressed equity values and a higher interest rate environment over the past two years, banks have faced an uphill battle in both raising new equity and raising new debt – the conventional ways in which to increase capital levels.
- The emerging answer to this problem for U.S. banks -- taking a cue from European banks – is to arrange bespoke "credit risk transfer" (CRT) transactions that involve choosing high quality loan pools and selling tranches of risk on those pools to third party investors. For banks, CRT is a tool that transfers risk without the need to raise equity capital at too low a price or issuing debt to the market at too high a price.
- EJF Capital, with its expertise in the small U.S. bank space (i.e., banks with less than $100 billion in assets), has been active in arranging attractive bespoke CRT transactions that meet both the needs of small banks seeking to raise capital levels and the low-to-high teens investment and return objectives of its clients.

The Uphill Battle Faced by Banks After the GFC

In the aftermath of the Global Financial Crisis (GFC), banks found themselves starring in their own financial spaghetti Western, "The Bad, the Good and the Ugly", the title used for a 2012 Economist article that likened the period to the movie that launched Clint Eastwood's movie career in 1966. In that article, the authors observed that there were three ways for banks to deleverage their balance sheets. The first – "the bad" – involves reducing the bank's debt, which correspondingly decreases the bank's loan activity. The second – "the good" – involves raising new capital, which by contrast promotes continued loan activity. And finally, the third – "the ugly" – which involves either or both strategies, but in a regulatory environment in which the government subjects banks to higher capital costs that it in turn passes on to borrowers.[1] In the four years following the GFC, the Economist saw the "ugly" unfolding: a long, slow slog in which banks tried to deleverage their balance sheets by any means possible, but at the same time fought the uphill battle of regulator-imposed higher capital costs. On balance, the loser was the U.S. borrower and derivatively the U.S. economy. Higher capital requirements within the regulated lending of banks, among other things, increased nonbank lending; as of December 31, 2023, only 21% of loans in the U.S. are made by regulated banks.[2] It also helped spawn the expansion of

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[1] R.D., "The Bad, the Good and the Ugly," The Economist, May 2, 2012: https://www.economist.com/free-exchange/2012/05/02/the-bad-the-good-and-the-ugly
[2] Federal Reserve Data as of Q4 2023.

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unregulated private credit, speculation in and lending of digital assets, and nonbank mortgage servicing. Each of these unregulated activities have been cited by the Financial Stability Oversight Council in the past two years as sources of potential financial instability.[3]

Nonetheless, in the decade after 2012, banks did what regulators demanded: increased their regulatory capital by both buying back or retiring debt and raising capital. The average Tangible Common Equity (TCE) Ratio for U.S. Commercial Banks today exceeds 9% versus less than 7% at the depths of the GFC in 2008.[4] Large banks generally greater than $100 billion of assets have been stress tested annually for severely adverse scenarios in-line with the GFC and passed with material levels of excess capital. Smaller banks below the Federal Reserve's threshold of concern also responded by consolidating at a steady pace, about 5% per year on average from 2010 to 2020.

Although banks struggled to excite investor interest except in spurts and starts after the GFC, all seemed tranquil on the U.S. banking front until the "Regional Banking Crisis" of 2023. The rapid rise in interest rates and concerns about commercial real estate exposures (particularly in office) left many banks exposed to renewed worries about bank balance sheets. The extreme cases of banks with more monoline deposit bases led to the deposit runs and subsequent collapses of Silicon Valley Bank, Signature Bank and First Republic. In each case, the FDIC and Federal Reserve had to effectively "insure" deposits by engineering mergers with healthier banks with the provision of generous government backstops.

Why CRT Transactions Have Emerged as a Regulatory Risk Management Tool

So where does this leave the US banking system now that there are palpable concerns about balance sheets and, in particular, CRE? Much like in 2012, it is not that easy or desirable given market prices for banks to go down the purely "good" path of simply raising capital (although that is happening to a greater degree than in 2012). For small and medium sized banks, raising equity is particularly unattractive as they trade at a P/E (price to equity) ratio approximately 42% below the S&P 500.[5] The "bad" path of reducing outstanding debt is also not desirable as any outstanding fixed debt was issued in a time of lower rates. In addition, the cost of raising new debt at today's higher interest rates is prohibitive.

One answer that has been emerging over the past year is a twist on the "good" option: freeing up regulatory capital through transactions called "credit risk transfers" (CRT), or in its European form, "significant risk transfers" (SRT). In such transactions, banks take certain of their "good" performing loan assets with low default rates -- such as prime jumbo mortgages, prime residential, prime auto and multi-family -- and put them in a special purpose vehicle and sell some first-loss or close to first-loss protection to a third party. Although banks have to pay the third party a

[3] https://www.debevoise.com/insights/publications/2023/12/fsocs-2023-annual-report-and-recent-revisions
[4] S&P Capital IQ Pro as of 12/31/2023.
[5] Bloomberg and S&P Capital IQ Pro as of 3/29/2024.

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reasonably competitive rate of interest (the premium) to take on the risk of default on such loans, they release capital for more productive loan activity in a high interest rate environment. CRT is therefore a tool that transfers risk without the need to raise equity capital at too low a price or issue debt to the market at too high a price.

As European investors know well, CRT/SRT debt transactions have been utilized for years by large, money center banks as a regulatory capital risk management tool in the wake of the GFC. According to the consultant Marsh McLennan, the European SRT market "has grown dramatically since 2012, reaching €165 billion in 2022."[6] The use of this risk management tool, however, had not been widely adopted in the U.S. In September 2023 that all changed when the Federal Reserve issued guidance that effectively sanctioned the practice. The Federal Reserve specifically stated that "credit linked notes" – one type of CRT debt that can be issued to the risk buyer – indirectly frees up capital by reducing the level of risk-weighted assets the bank holds: "There are various forms of instruments referred to as credit-linked notes, which firms can use to reduce their risk... In certain instances, the capital rule recognizes when a firm has utilized these instruments as a form of risk mitigation and permits a firm to reduce its risk-weighted assets to reflect the risk mitigation."[7] Since this explicit guidance, banks in both Canada and the U.S. have ramped up their efforts to identify opportunities to issue CRT in a way that efficiently frees up capital for new lending activity.

The Investor Opportunity in CRT, Especially in U.S. Small Banks

Investors should note that CRTs are not just a benefit for the banks. Beyond the healthy returns CRTs offer, the most important consideration for investors is the creditworthiness of the loan assets being utilized as the reference pool upon which CRTs are issued. For one, the loans by definition are on the balance sheet of the bank, so they are loans the bank wanted to hold the risk of when they were originated. Indeed, the bank maintains the reference pool loans on their balance sheet even with a CRT. Second, in order to efficiently free up capital, the bank is incentivized to utilize its best assets in order to minimize the risk premium paid to the risk-taker. Although CRTs are bespoke transactions, the bank often has to assume the first loss to the extent of the historic losses on the loans being referenced. This also protects investors. Finally, it should be emphasized that an investor is not taking the risk of the bank itself – an important sentiment consideration after the Regional Banking Crisis -- but rather a slice of like loans that the investor can specifically underwrite, and in many cases, help choose.

EJF believes the CRT opportunity in small banks is especially attractive. EJF estimates that since 2022 there have been approximately 30 transactions conducted by banks that used a CRT structure

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[6] "Expanding the portfolio management toolkit: A primer on Credit Risk Transfer (CRT) solutions for North American Banks" (2024).
[7] September 28, 2023, https://www.federalreserve.gov/supervisionreg/legalinterpretations/reg-q-frequently-asked-questions.htm

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referencing U.S. based loans.[8] The CRTs have spanned multiple asset classes with reference pools exceeding approximately $70 billion. But the CRT tool is only a nascent one for smaller banks, as only five CRTs have been issued by banks with less than $100 billion in assets and three CRTs issued by banks with less than $25 billion in assets. EJF estimates that the 2,786 banks with under $100 billion in assets can potentially issue CRTs in aggregate of greater than $200 billion over the next few years.[9] EJF believes both that banks and regulators are particularly focused on small bank CRE exposure and that CRT transactions on their best CRE assets – typically loans on multi-family residential – can help address this exposure.

EJF has helped arrange two CRT transactions with banks less than $100 billion in assets. One involved development loans on senior nursing facilities for a Midwestern Bank that are ultimately purchased by the U.S. government after a period of seasoning, and another on prime jumbo mortgage pools for a U.S. Bank. Each was a bespoke transaction with the ability to review and negotiate the inclusion/exclusion of specific loans. The low-to-high teen rates on these two CRT transactions were attractive, especially given the historically low loss rates on such loans. From EJF's perspective, the risk/reward attributes of such CRT transactions are extremely attractive and reflect the nascent and emerging market in U.S. small banks.

Conclusion

CRT transactions represent a powerful tool for banks to optimize their balance sheets, manage risk and comply with regulatory capital requirements, while at the same time creating opportunity for investors. Like the "The Good, the Bad and the Ugly" – il buono, il cattivo, il brutto – which helped promote the unexpectedly popular Italian influence on the "spaghetti Western" film genre[10], European-inspired CRT transactions, particularly for small U.S. banks, represents a new frontier of opportunity given the increased regulatory focus on such institutions due to their substantial CRE holdings. Given our deep expertise within the small bank sector, and success arranging two transactions to date, EJF stands ready to play its role. Small banks are certainly watching and listening.

[8] EJF estimate.
[9] EJF estimate.
[10] "Quentin Tarantino – The good, the bad and the movie geek," May 13, 2011 https://www.independent.co.uk/arts-entertainment/films/features/quentin-tarantino-the-good-the-bad-and-the-movie-geek-2283148.html

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