Lone Star rising

It took Texas Capital Bank nine months to finalise its landmark capital relief trade, becoming the first US regional bank to tap the risk transfer market. **Simon Boughey** tracks the deal's progress from inception to launch.

When Texas Capital Bank began to contemplate issuing a capital relief trade in late spring of 2020, it was not the first time that the Dallas-based lender had looked at a stratagem designed to improve its balance sheet. It explored whether to bring a securitisation in 2016, for example, and a year later examined the possibility of a risk-sharing partnership with other banks. But neither of these achieved the goals of keeping the revenue on the balance sheet while at the same time securing the accounting treatment required for effective capital relief.

However, the CRT mechanism was the game-changer. TCBI was researching different options in April-May 2020 when Citi, a veteran of the market as issuer and underwriter, presented its version of the trade. This clarified the route for TCBI: after being pitched the notion, the bank spent the next two quarters researching CRT from all possible angles and came to the conclusion that it would hit the bullseye.

"We had been pitched a number of options over time and with each one there was always some technical piece that was an insurmountable obstacle: whether the regulators deemed it acceptable, whether it achieved the accounting policy requirements, whether it was a true transfer of risk – each one of them never quite made it," says Madison Simm, evp, business optimisation at TCBI.

The search had been both prolonged and patient as TCBI has more reason than most lenders to seek capital relief. Some 40% of its assets are denominated in warehouse loans to around 200 non-bank mortgage originators, making it the biggest warehouse lender among US regional banks.

It extends credit to cover between 95% and 99% of unpaid mortgage principal balance to the client to finance origination, prior to securitisation. This type of lending was particularly harshly treated by the new US bank capital rules that were unveiled by the OCC, the FDIC and the Federal Reserve in July 2014.

Incorporating the precepts of the Basel 3 framework, the new guidelines applied a revised version of the standardised approach for regulatory bank capital. As the regulators noted in their introduction to the 2014 rule, published in the Federal Register on 30 July 2014: "Among other changes, the 2013 capital rule amended the methodologies for calculating risk-weighted assets under the advanced approaches, as well as the standardised approach for regulatory capital in subpart D (standardised approach) of the 2013 capital rule, which is generally consistent with the methodologies for calculating risk-weighted asset established by the Basel Committee on Banking Supervision (BCBS) through its international framework." ▶

Madison Simm, TCBI

What this meant for TCBI was that warehouse loans were treated as consumer lending and received the full 100% risk weighting. If it had been offering mortgages as a principal, then these assets would have received only a 50% risk weighting, but warehouse lending was viewed as a commercial line of credit.

This is despite the fact that the loans are on TCBI's books for only around 30 days before the mortgages are securitised and are also 100% QM and GSE-eligible. In fact, TCBI has never had a loss in this form of lending.

"We were very confident that the risk weighting applied to this asset was dislocated from the actual risk, but the regulators viewed it as appropriate, as it is seen as a commercial line of credit. So our next thought was 'Can we develop a pathway to transfer a portion of that risk to the investor?'" explains Simm.

For six years the quest for that pathway was frustrated, but in mid-2020 light dawned at the end of the tunnel when Citi made its overtures. But much work remained to be completed. Having been shown the blueprint, Simm and his team commenced a four-month deep research project.

The bank contracted the services of KPMG to conduct much of the vital policy and regulatory research and, at the end of that period of four months, a 50-page white paper had been produced. "From June 2020 onwards, we spent every waking moment with our research partners KPMG going through every capital regulation book, every precedent, every other type of deal with a fine tooth comb," says Simm. They also examined in detail the ill-fated JPMorgan trade from late 2018, which was pulled after the regulators gave it the thumbs down.

Armed with his voluminous white paper, Simm then began a tour of the C-level suite and the board to convince senior management that a CRT deal was not only practicable, but would also substantially improve the bank's capital status. Approval to go ahead was granted and work on the actual transaction began in the middle of October, some five months before the deal priced. Citi was an integral part of this process and, according to sources, it also introduced TCBI to Clifford Chance – a law firm with extensive expertise in the CRT market, for legal and documentation work.

Citi has had more experience of the CRT market than any other US bank. It has been using the mechanism as a tool to improve its own balance sheet since 2007.

"All our decisions were based on our experience executing transactions for our own balance sheet," says Mark Kruzel, global spread products, FIG solutions at Citi.

A key part of the structure developed was that it would be a CLN. A common or garden securitisation wouldn't fit the bill, as the assets are taken off the balance sheet.

But a CLN means that the warehousing programme remains on the balance sheet. The investor takes the first loss and receives in return a preferred yield – in this case, Libor plus 450bp. But in spite of this generous coupon, the transaction remains earnings neutral, as the extra capital capacity created allows TCBI to take on more business and replenish the revenue.

amicable relationship with the OCC, the FDIC and to a lesser extent the Fed.

The bank never takes a step without fully informing the chief regulators of its intentions and strategy, and this stood it in good stead. As Simm notes, TCBI is not a global bank which has used this type of financial technology in the past.

Nonetheless, starting in October 2020, an exhausting three-month discussion and negotiation period was required. The bank made an initial presentation to the OCC and the FDIC, and then the regulators called it back in for more detailed explanations and Q&A sessions.

"[The regulators] were constructive. They are very aware that this technology is out there; they are aware that other regional banks are researching this. But it is still new to them so they had a series of technical experts on regulatory rules, the securitisation markets, etc and these experts are brought to these calls to ask probative questions and we were happy to answer those questions," says Simm.

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"The CLN structure also creates fewer regulatory headaches, because there is no swap and therefore no swap regulatory issues," comments David Felsenthal, a partner with expertise in structured finance, at Clifford Chance in New York.

Clearly, the next four months or so until launch were dominated by discussions with the regulators. Unless the regulators could be convinced that actual transfer or risk would be accomplished, they would not give the deal the green light. And while US regulators have become more au fait with the capital relief trade mechanism over the last year or two, they are not as comfortable with it as European regulators.

Moreover, this was the first deal by a US regional bank and the first US CRT deal to reference a pool of warehouse loans. Their assent was by no means certain.

TCBI also had to deal with three different regulators – the OCC, the FDIC and the Fed – which made the whole experience more cumbersome and protracted than is customary in Europe. The ground had been well-prepared by TCBI, as it has spent years fostering a good and

Unsurprisingly, the nitty gritty of regulatory capital rules and how the proposed transaction would qualify the underlying assets for more lenient risk weighting under standardised rules were fully investigated. But, crucially, the regulators wanted to be sure that this was not a one-off deal but part of an ongoing strategy. They did not want to see TCBI complete a single trade and then face a capital cliff when the deal matures.

Once they became satisfied on this point, the tone of the conversation changed and the

Mark Kruzel, Citi

David Felsenthal, Clifford Chance

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regulators became collaborative and constructive. Simm pays tribute to the role played by KPMG during this gruelling process: "We wouldn't have wanted to go through this alone. Having KPMG in our corner to help with the research and preparation was hugely beneficial."

As Kruzel says, this type of detailed planning is essential in the US as there is no prescriptive guidance from regulators. Each would-be issuer needs to build its own internal standards and make sure that the infrastructure is in place before proceeding any further.

TCBI had to demonstrate to regulators that it has the infrastructure to deal with the day-to-day itemisation of warehouse loans and the seamless creation of a pool of loans for the CRT market. The bank has US$10bn of residential loans on its balance sheet, and the average loan size is US$250,000. It adds about 10,000 new loans every month, and it has a bespoke in-house system to manage the pool of debt.

But it has specific CRT technology which not only creates a reference pool of loans, but can also be halted if there is a credit event on any of the loans. Each loan has to meet specific criteria before it can be included in a CRT pool, and a system attests on a daily basis that the reference pool meets all the specified obligations.

The regulators needed to see and understand every aspect of this process. They also needed to be shown TCBI's investor reporting procedures, which was an onerous undertaking as TCBI has no regular capital markets presence.

"It was a major ordeal. We had to stand-up a process to facilitate investor reporting requirements. We have four or five of fractional resources across our team that are taking a piece of the operational requirements. The regulators wanted to see and feel each piece of [the operational preparedness] to become comfortable with the CRT," says Simm.

The regulatory green light was flashed in January, and TCBI could then begin the process of bringing the deal to market. It was not out of the woods yet though.

Warehouse loans are very high quality, and thus it was going to be challenging to find buyers for this type of asset. As Kruzel notes: "It's difficult to create an investor base for middle mezzanine exposure."

The first loss tranche attaches at 0% and detaches at 12.5%. This is much thicker than is common in European deals.

The coupon of Libor plus 450bp – though generous, compared to many investment opportunities in the US debt market at the moment – is much thinner than is the case in Europe. Tranches of 0%-6% paying 11% or 12% are usual in European markets.

In the end, TCBI's debut CRT was sold to two investors in March, both of whom are said to be well-known names in the space. The three-year CLN paid Libor plus 450bp on a US$2.2bn portfolio of mortgage warehouse loans, with a first loss position of US$275m, or 12.5%.

This first loss tranche was risk weighted at zero, while the remaining US$1.925bn of loans carries a risk weighting of 20%. Thus, the risk weighting on the entire pool of US$2.2bn drops from 100% to 17.5%, reducing RWA by US$1.815bn.

According to analysis carried out by Keefe, Bruyette & Woods, this drastic reduction of risk weighting will have boosted TCBI's Tier One capital ratio by 73bp from 10.92% to 11.66%, while total risk-based capital ratio will have increased by 85bp from 12.76% to 13.61%. This significant creation of excess capital could be used to increase the size of the mortgage warehouse by up to US$500m, according to the research.

It has been a long and arduous road for TCBI, but the rewards are clear. The bank also executed a US$300m perpetual preferred offering in the same quarter it issued the debut CRT. But in terms of creation of capital relief, the CRT was the more effective trade.

Other US banks, particularly those with large warehouse lending books, are thought to be looking at the structure. Regionals thought likely to follow the example set by TCBI include First Horizon (headquartered in Memphis, Tennessee), Flagstar Bank (based in Michigan), Independent Bank Corporation (based in Texas) and Veritex Community Bank (headquartered in Dallas, Texas). None of these banks have commented on whether they are likely to dip their toes into the waters of CRT.

According to data from Inside Mortgage Finance and quoted by S&P Market Intelligence, the most active warehouse lenders in 4Q20 were JPMorgan, Flagstar, TIAA Bank of Jacksonville, Florida, Merchants Bank of Indiana and Wells Fargo.

"CRT should be thought of as a capital tool. If you're looking for balance sheet optimisation, the precedent has been set," Kruzel concludes.