Managing Capital-Retention Requirements Using Credit Risk Transfer

The recent collapse of Silicon Valley Bank is causing regional banks to consider measures to increase their regulatory capital. This can be achieved through various techniques, including the use of credit risk transfers (CRTs).

What are CRT transactions? In CRT transactions, banks, insurance companies, specialty lenders, etc. (Protection Buyers) pay to transfer credit risk from their portfolios to a counterparty (Protection Sellers). In a CRT transaction, a portfolio or tranche of loans remains on the Protection Buyer's books, but without the credit risk, which was transferred to the Protection Seller. CRT transactions can be applied to a variety of assets—commercial and residential mortgage loans, secured and unsecured consumer or commercial loans, corporate loans, auto loans, etc. In addition to reducing a Protection Buyer's risk of loss from the underlying portfolio, CRT transactions also reduce the amount of regulatory capital they need to hold under Basel III standards.

According to Asset Backed Alert,[1] one possible reason for the failed first attempt by the FDIC to sell Silicon Valley Bank was its capital-intensive subscription lines, which even banks like Citi are scaling back. Regional banks could utilize CRT transactions to manage their capital retention requirements. According to Fitch Ratings,[2] there has been increased usage of CRTs by U.S. regional banks since early 2021.

A key challenge after the completion of a CRT transaction for the Protection Seller is estimating the fair value of the CRT transaction assets as required under ASC 820. This can be a complex exercise because most CRTs are bespoke, with varied counterparties, operational and asset-specific risks, and limited transaction volumes.

Houlihan Lokey has significant experience in valuing CRT transaction assets held by the Protection Sellers. We currently value transactions on monthly, quarterly, and yearly intervals for our clients. Houlihan Lokey's analytical expertise in valuing CRTs encompasses multiple asset classes—CLOs, consumer whole loan pools and ABS, commercial and residential real estate investments, and various corporate loan structures. In addition to our experience, we benefit from our proprietary database of implied transaction discount rates (stemming from related transaction data, tranche attachment/detachment points, projected investment losses, weighted-average life of investments, replenishment periods, and coupon and collateral types), leading to more precise valuations and effective discussions with clients and auditors. Our historical collateral performance metrics by deal and our proprietary CRT pricing model allow clients to corroborate their expectations and support future collateral performance expectations. Our experience interacting with auditors, regulators, investors, fund administrators, and other relevant parties positions us well to defend pricing valuation marks, if challenged. Our ability to cross-team with our Corporate Finance and Financial Restructuring teams, when needed, further enhances our viewpoint on expected collateral performance. Our experience set exists across CRT transactions in the U.S., U.K., Canada, and Europe.

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Please contact us for further information on CRTs and our experience.

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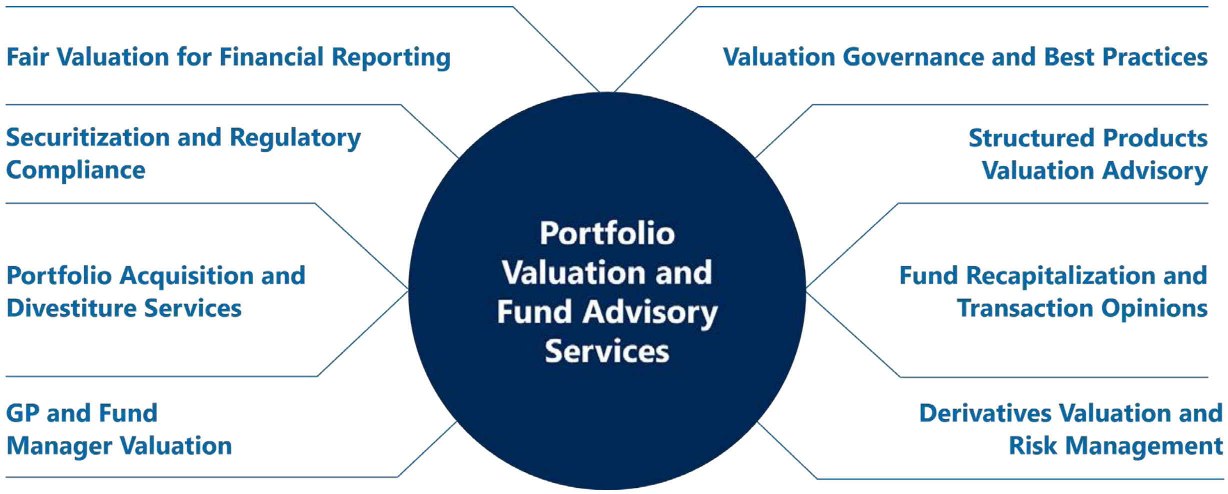
(1) Asset-Backed Alert. March 17, 2023.

(2) Fitch Ratings, SPECIAL REPORT—U.S. Banks Credit-Linked Notes: Balance Between Risk Transfer and Capital Arbitrage (Increased Usage by U.S. Regional Banks Could Lead to Earnings and Capital Impact). December 13, 2022.

ABOUT PORTFOLIO VALUATION AND FUND ADVISORY SERVICES

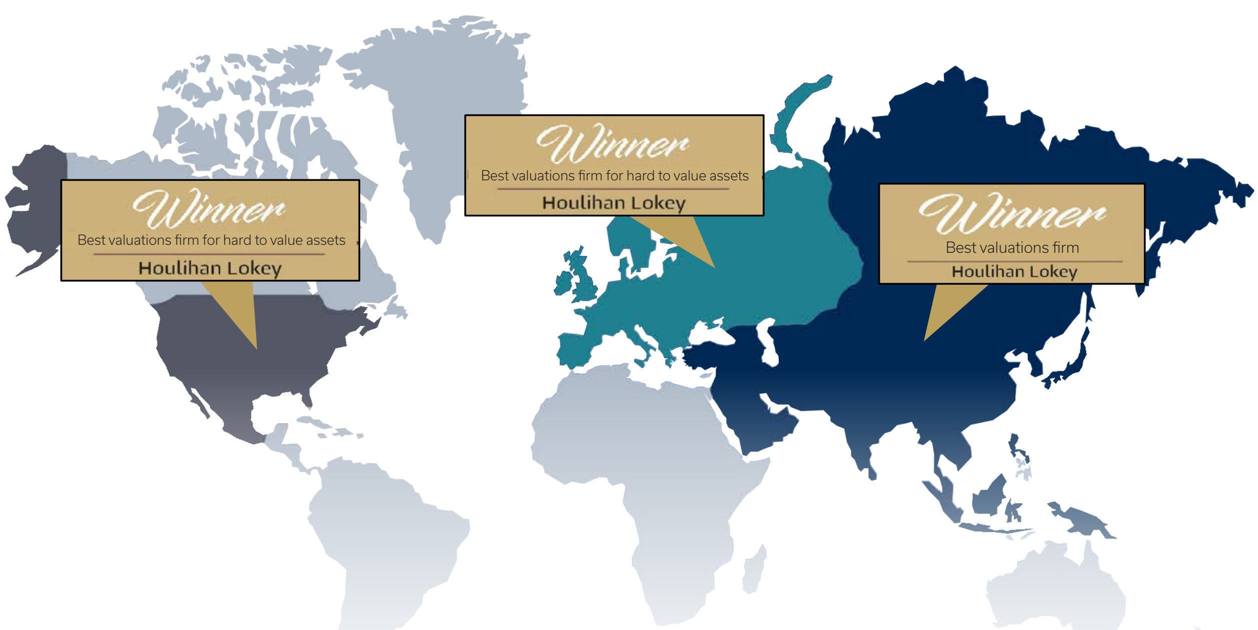
Houlihan Lokey's Portfolio Valuation and Fund Advisory Services practice is a leading advisor to many of the world's largest asset managers who rely on our strong reputation with regulators, auditors, and investors; private company, structured product, and derivative valuation experience; and independent voice. We value illiquid assets on behalf of hundreds of hedge funds, private equity firms, financial institutions, corporations, and investors. We rapidly mobilize the right team for the job, drawing on our expertise in a wide variety of asset classes and industries along with our real-world transaction experience and market knowledge from our dedicated global Financial and Valuation Advisory business.

OUR SERVICE AREAS



GLOBAL RECOGNITION

The HFM Services Awards named Houlihan Lokey "Best Valuations Firm for Hard to Value Assets" in the U.S. in 2018–2022 and in Europe in 2020–2022, and it was named "Best Valuations Firm" in Asia in 2020–2022. Houlihan Lokey has now won these awards in all three geographic regions for three consecutive years!



HFM AWARDS

The HFM Services Awards recognize hedge fund service providers that have demonstrated exceptional client service, innovative product development, and strong and sustainable business growth over the prior 12 months.

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