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Cabinet News and Views

Informed analysis for the financial services industry

Alphabet Soup

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In This Issue ...

There's lots to cover in this week's issue – news from the alphabet soup of U.S. regulatory agencies (in this case, the CFTC and CFPB), as well as important updates from the UK and Europe.

We also encourage you to read the comprehensive analysis of capital relief trades and, especially, to register for our upcoming webinar series.

As always, we welcome your thoughts on this week's issue of *Cabinet News and Views* and other timely topics. Just write to us here.

Daniel Meade and **Michael Sholem**
Co-Editors, *Cabinet News and Views*

CFPB Launches Office of Competition and Innovation

By **Rachel Rodman**
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On May 24, the CFPB launched a new office, the Office of Competition and Innovation. The stated purpose of the new office is to promote competition and innovation that benefits consumers in the financial products and services market. Specifically, the Office of Competition and Innovation will (1) explore ways to reduce barriers to consumers' ability to switch accounts and providers, (2) research market-structure problems that create obstacles to innovation, and (3) work with stakeholders to identify and challenge existing market structures that harm consumers. The office will be housed in the CFPB's Division of Research, Markets & Regulations.

The Office of Competition and Innovation replaces the CFPB's Office of Innovation and Project Catalyst. The primary purpose of these programs was to process applications for No Action Letters and Sandboxes that applied to an individual company's specific product offering. In the CFPB's May 24 announcement, the agency stated that, "[a]fter a review of these programs," it concluded that "the initiatives proved to be ineffective."

The CFPB's statutory mandate under the Dodd-Frank Act includes ensuring that "markets for consumer financial protects and services are fair, transparent, and competitive." 12 U.S.C. § 5511. Yet the Bureau has not historically focused on competition initiatives, and it is unclear how the statutes it administers would be (or could be) applied to address anti-competitive conduct as distinct from consumer protection violations. Indeed, the CFPB's May 24 announcement acknowledges that the agency will coordinate with "Federal, State, and international regulators on matters related to competition and innovation." Precisely how a focus on ensuring "competitive" markets for consumer financial services will influence the CFPB's future rulemaking and enforcement priorities remains to be seen.

CFTC's Swap Reporting Advisory

By Peter Y. Malyshev
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Accurate and timely reporting of swap data is the cornerstone of swap regulation. The CFTC had promulgated its swap reporting rules in 2012, and were after 2012 among the first rules implementing the Dodd-Frank Act to require, among other things, the anonymized real-time reporting of swap data (Part 43 of CFTC regulations) as well as more detailed regulatory reporting of swap data (Part 45) to swap data repositories ("SDR"). These reports must be provided by swap dealers (or the end-users that are trading with other end-user counterparties), swap execution facilities ("SEFs"), designated contract markets ("DCMs"), and derivatives clearing organizations ("DCOs"). Swap data includes both the primary economic terms of the swaps when they were entered into (creation data) as well as any material amendments and cancellations or terminations of swaps (continuation data).

Since 2012, there have been numerous CFTC enforcement actions sanctioning swap dealers and other reporting parties for failing to comply with reporting rules, and, in fact, the CFTC's surveillance considers reporting a "low hanging fruit" because some mistakes can be found at almost any reporting party. Conversely, market participants have noted that the 2012 reporting rules were ambiguous in many aspects as drafted, which leads to reporting mistakes.

With this in mind, the CFTC had amended its reporting rules in November 2020 to clarify many of the provisions, including Parts 43 and 45. The compliance date under the amended rules was May 25, 2022. However, the staff of the CFTC realized that the market was still struggling with implementation of the new rules, and on January 31, 2022 issued no action letter No 22-03 postponing compliance to December 5, 2022.

One of the requirements of the rules is to correct swap data that had been submitted to the SDRs if it is later discovered that the data was erroneous. On June 10, 2022, the CFTC issued advisory No 22-06 ("Advisory") clarifying how correction reports must be submitted to the SDRs and, if they cannot be submitted timely, to the CFTC with the remediation plan.

Further, the Advisory reminds reporting parties that many of the swaps that have been terminated remain reported as "open" on SDR's records, which significantly distorts CFTC's surveillance of the markets and assessment of the overall systemic risks. It is a violation of the reporting rules not to submit the continuation data indicating that the swaps have been terminated. Swap trading entities should continue monitoring CFTC's guidance as it is likely that further advisories will be issued before the compliance date.

Basel Committee Issues Principles on Management and Supervision of Climate-Related Financial Risks

By **Daniel Meade**
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On June 15, the Basel Committee on Banking Supervision ("BCBS") issued its Principles for the effective management and supervision of climate-related financial risks (the "Principles"). In its release, the BCBS stated that it "aims to promote a principles-based approach to improving both banks' risk management and supervisors' practices related to climate-related financial risks." The publication of the Principles follows an initial consultation document issued in November 2021.

The Principles described 18 principles the BCBS suggests be implemented as soon as possible. The 18 principles relate to corporate governance, internal controls, risk assessment, and management and reporting.

The first 12 principles are aimed at banks; the remaining six principles are aimed at bank supervisors. Principle 13 offers possibly a synthesis of most of the BCBS Principles. It states: "Supervisors should determine that banks' incorporation of material climate-related financial risks into their business strategies, corporate governance and internal control frameworks is sound and comprehensive."

The BCBS Principles seem to be broadly in accord with principles that the OCC and FDIC put out for comment in December 2021 and March 2022, respectively. The Federal Reserve Board has not yet issued such principles, but the issuance of BCBS principles, together with possibly having a confirmed Vice Chair for Supervision soon, could spur similar action from the Fed.

In Depth: Latest Compromise Text in Relation to AIFMD2 Proposals on Loan Origination Funds


By **Michael Newell**
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By **Michael Sholem**
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On 1 June 2022, the French Presidency published its “final” compromise text in relation to the revision to the EU Alternative Investment Fund Managers Directive[1] (known as “AIFMD2”).

According to this latest AIFMD2 Proposal, the following requirements would apply:

Definition of “loan origination”

Importantly, the compromise proposal includes a definition of “loan origination” being the “granting [of a] loan by an AIF as the original lender.” AIFs that acquire loans are referred to as “loan-partipating AIFs,” and provisions that are intended to cover both loan-originating AIFs and loan-participating AIFs now make that clear.

Various provisions also now expressly state that AIFs that gain exposure to loan origination through SPV vehicles are treated as “loan-originating.”

Leverage limit

The introduction of a leverage cap has always been one of the more controversial proposals and this remains, albeit it now more clearly surrounds only the issue of loan generation. The cap in the final compromise text has been reduced to 150% of the net asset value of the AIF. Were this to end up in the final text, it will be disappointing to the industry. Although there is still scope for this to be negotiated by MEPs, it is apparently a key consideration for a “vast majority” of Member States within the Council.

Leverage for these purposes is calculated using the “commitment” method, and borrowing arrangements that are temporary in nature and are fully covered by contractual capital commitments from investors in the AIF do not constitute leverage for these purposes.

Closed-ended vs. open-ended

Previously there has been a proposal that loan-originating AIFs (or AIFs exposed to loan origination through SPVs) should be closed-ended. Whilst this is still a stated requirement, the compromise text has now included a key derogation to confirm that a loan-originating AIF may indeed be open-ended provided that its liquidity risk management system is compatible with its investment strategy and redemption policy.

Investment objectives and ban on “originate-to-distribute”

No AIF which originates loans (directly or through exposure to loan originating SPVs) may have a strategy which has as a purpose the transferring of its loans or exposures to third parties ("originate-to-distribute"), except in circumstances where it has to meet redemption requests or to comply with its investment and diversification rules.

Risk retention obligation

Another controversial measure is a proposal that a loan-originating AIF must retain 5% of the notional value of the loans it has originated and subsequently sold on the secondary market. The EU Parliament had proposed the ban on "originate-to-distribute" strategies instead, but the compromise proposal has taken up both.

However, the original retention proposal has been adapted to apply for a two-year period from the signing date or until maturity (whichever is shorter) rather than on an ongoing basis. It also now applies to loans originated or purchased from a special purpose vehicle that originates a loan for or on behalf of the AIF or AIFM in respect of the AIF.

Credit policies and procedures

AIFMs of loan-originating AIFs must implement effective policies, procedures and processes for the granting of credit. AIFMs of both loan-originating AIFs and loan-participating AIFs must establish, maintain up-to-date, and review at least once a year policies and procedures for the assessment of credit risk and the monitoring of credit portfolios.

"Shareholder loans" – exemption for private equity and real assets

In order not to capture AIFs that ordinarily make loans to their investee companies and SPVs (as most real estate, infrastructure and private equity funds do), there is a specific carve-out of the leverage cap and the credit policies requirements for AIFs that make "shareholder loans," which are defined as:

"an advance on current account granted by an AIF to an undertaking in which it holds directly or indirectly at least 5% of the capital or voting rights and which cannot be sold to third-parties independently of the capital instruments held by the AIF in the same undertaking"

and in situations where the origination of shareholder loans:

(i) do not exceed in aggregate 100% of the AIF's capital; or

(ii) are granted to portfolio undertakings that acquire and manage real estate or participations in real estate companies, and in which the AIF directly or indirectly holds 100% of the capital or voting rights. This requirement shall apply on a look-through basis to underlying assets controlled directly or indirectly by the AIF or the AIFM acting on behalf of the AIF.

"Capital" for these purposes is now defined as "aggregate capital contributions and uncalled committed capital, calculated on the basis of amounts investible after deduction of all fees, charges and expenses that are directly or indirectly borne by investors."

Concentration limits for financial borrowers

The percentage of the AIF's capital (as defined above) that may be lent (by the AIF or any subsidiary vehicle) to a single borrower that is either a financial undertaking, an AIF or a UCITS is capped at 20%, subject to exceptions for ramp-up and wind-down periods.

Conflicts of interest

A loan-originating AIF cannot lend to its AIFM, the AIFM's staff or delegates or its depositary.

Grandfathering

The concept of a grandfathering period is now included in relation to existing loan-origination funds. Currently, the compromise text states that this will be for a suggested period of five years from the date of adoption of the new directive. In addition, these changes shall not apply to funds that were established prior to the date of the new directive and do not raise any additional capital subsequently.

Timing

The French Presidency ends on 30 June 2022, and there is one further meeting scheduled this month of each of the Council and the Commission including a discussion on final AIFMD2 positions on the agenda. The European Parliament are considering the Rapporteur's report and have until 27 June to submit final amendments. MEPs are then expected to agree on their final text but probably not until after the summer.

The process will be picked up by the Czech Presidency, which is expected to lead trilogue discussions this autumn with a view to agreeing a final text should be agreed prior to the end of the year. The new directive will come into force two years from its publication in the EU Official Journal, although we expect that the new rules will be implemented rapidly in Luxembourg and Ireland, in particular.

[1] Directive 2011/61/EU

In Brief: Regulation Q and You – Capital Relief Trades for U.S. Banks


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By **Daniel Meade**
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Over the last 18 months, we've seen a sharp uptick in inquiries from U.S. banks about how to use capital relief trades to manage regulatory capital constraints. Here, we set out our responses to some of the frequently asked questions we've received on this topic. If you're interested in learning more, we invite you to join us for a free webinar series beginning on June 22, where we'll discuss capital relief trades in greater detail.

What is regulatory capital?

Every U.S. bank[1] is required to hold a minimum amount of capital to absorb losses. U.S. bank capital rules, which are codified in a federal regulation known as Regulation Q,[2] require a minimum amount of capital under both a leverage ratio, which is generally calculated as capital over a bank's total assets, as well as a risk-based ratio, which is generally calculated as capital over a bank's risk-weighted assets (or "RWAs").[3] In this article, we refer to bank capital requirements under the risk-based ratio as "risk-based" capital requirements.

What are capital relief trades?

Bank capital requirements are intended to minimize the likelihood of bank insolvency. However, holding regulatory capital can be costly for banks, and for a bank that is capital-constrained, it may make sense to explore a capital relief trade, which, as the name suggests, is any transaction that has the effect of optimizing a bank's regulatory capital profile – in particular, as it relates to *risk-based* capital. Capital relief trades can be used for other reasons as well, such as managing credit risk. In the fund finance context, these transactions can also help a bank manage portfolio-level concentration limits, such as a cap on single-sponsor exposure, while retaining those existing lending relationships.

Capital relief trades go by many names, such as credit risk transfer, significant risk transfer and risk-sharing. The acronyms "CRT" and "SRT" are commonly used to describe these trades, although in our experience, "CRT" appears to be the preferred nomenclature in the U.S., whereas "SRT" is more common in the international market.

What do CRTs look like?

In general, all CRTs share three common features. First, a bank must transfer the credit risk associated with its RWAs to one or more third parties. Second, that transfer of credit risk must be effectuated on a tranched (*i.e.*, senior/sub) basis, with the bank transferring the subordinate (*i.e.*, first-loss) tranche of credit risk and retaining the senior (*i.e.*, second-loss) tranche. Third, the investors acquiring the first-loss tranche of credit risk must do so on a collateralized or funded basis.

So long as a CRT contains these three features, it can be structured in any number of ways, each of which has its own pros and cons. The most basic way to group CRT structures is between bilateral and multilateral CRTs. Bilateral trades include credit default swaps and financial guarantees; multilateral trades include various securitization products.[4] Bilateral CRTs may be easier to negotiate since there is only one counterparty, but multilateral CRTs may offer benefits as well: syndicating credit protection to a wider universe of investors and issuing CRTs in a securities format that can be easily leveraged (for example, by repo) may result in more competitive pricing.

Multilateral trades can be in the form of cash or synthetic securitizations. In order to recognize a capital benefit from a cash securitization, the bank must be able to derecognize the securitized RWAs for GAAP purposes. This requirement − which has become harder to fulfill as a result of certain post-financial crisis changes to the GAAP rules − does not apply to synthetic securitizations, which may be an advantage to using the latter structure. Synthetic securitizations, which do not require assigning RWAs into an SPV, may also be cheaper and less administratively burdensome than cash securitizations.

Synthetic securitizations involve the issuance of credit-linked notes (or “CLNs”) by either the bank or a newly formed SPV. In the U.S., synthetic securitization CRTs have been predominately in the form of bank-issued CLNs, and while SPV-issued CLNs have been widely used in SRT transactions outside the U.S., that market is also migrating toward the bank-issued CLN model. When compared to bank-issued CLNs, SPV-issued CLNs raise additional regulatory issues, such as Volcker, commodity pool operator registration and CFTC swap regulation. Those additional regulatory issues can be addressed with proper structuring, but we note that the SPV-issued structure also generates additional costs and expenses, such as those associated with forming and administering an SPV. Further, CRT investors have generally not required that U.S. banks utilize SPVs, presumably because most issuing banks have credit profiles that are better than those of the first-loss positions being synthetically securitized (and therefore investors do not require an SPV to isolate the CLN issuance proceeds from the estate of the issuing bank).

What capital benefits does a CRT provide to a bank?

CRTs can provide banks with substantial risk-based capital relief by converting loans and other RWAs into “securitization exposures.” For this purpose, Regulation Q takes a principles-based approach: any transaction that transfers credit risk on a tranched basis can be a “securitization,” even if the transaction in question isn’t in the form of a securitization. So, for example, all of the different types of CRTs described above − including credit default swaps and financial guarantees − could be “securitizations” for Regulation Q purposes, provided they embody these substantive economic principles.

A CRT involves a bank transferring a first-loss tranche of the credit risk associated with its RWAs to one or more third parties, while retaining a senior tranche of that credit risk. Depending on the particulars of the structure − and assuming no currency or maturity mismatches between the CRT and the RWAs − the first loss tranche of the CRT could receive a 0% risk weight, and the senior tranche could receive a risk weight as low as 20%. For example, a $1 billion loan portfolio with a 100% risk weighting (assuming an 8% regulatory capital requirement) would have $80 million of associated regulatory capital ($1 billion x 8% x 100%), but if that portfolio were synthetically tranched into first-loss and senior risk positions with $125 million and $875 million face amounts (*i.e.*, 12.5% tranche thickness for the first-loss tranche), the regulatory capital associated with the portfolio could be reduced to $14 million ($875 million x 8% x 20%). In that example, the first-loss tranche would have $0 of associated regulatory capital ($125 million x 8% x 0%).

What kinds of RWAs are eligible for CRTs?

Any "financial exposure" can be synthetically securitized for capital relief purposes. This would include certain fund finance products (such as capital call subscription facilities), as well as corporate loans, commitments, receivables, derivatives, debt and equity securities, and mortgages. Depending on the RWAs in question, it may make sense to structure the CRT with a dynamic reference portfolio that allows the bank to substitute, remove and add RWAs (subject to a pre-defined set of asset- and portfolio-level criteria) over a specified replenishment period.

Are there other specific terms that a CRT must contain?

Regulation Q prescribes a number of terms that must be present in any CLN or CDS transaction. These include required credit events and settlement and valuation terms, as well as guidance around what to do with the cash proceeds from the CLN issuance (or, in the case of a CDS, cash collateral). Regulation Q also identifies a number of terms that a CLN <u>cannot</u> have: for example, all clean-up calls must be "eligible" clean-up calls (*i.e.*, exercisable at a 10% threshold), and the CRT cannot contain terms designed to protect or benefit the CLN investors if the credit profile of the RWAs deteriorates. Such "credit-negative" investor protections would include an increase in the CLN coupon, the right to put the CLNs back to the issuing bank or favorable adjustments to the attachment or detachment points.

What other legal and regulatory issues are relevant to CRTs?

Structuring a CLN will require navigating various U.S. legal issues, including tax treatment, Commodity Exchange Act issues, Dodd-Frank risk retention and insurance regulation. However, probably of most interest to issuing banks is the degree of disclosure that must be made with respect to the RWAs. In tension here are the confidentiality terms and the proprietary nature of the RWA documentation, on the one hand, and the anti-fraud provisions of federal securities laws, on the other. Any CLN issuer will have to carefully craft disclosure that balances these two concerns, while also disclosing any relevant risk factors. Finally, we note that if the CLNs are to be issued to offshore investors, it may also be necessary to consider the impact of EU, UK and/or Japanese securitization regulations.

All of this should give you a good introduction into CRTs. We'll be going into all of these topics in more detail during our upcoming webinar series, and we hope to see you there.

[1] In this article, we use the term “bank” to refer to both banks and bank holding companies.

[2] 12 C.F.R. Part 217 (Regulation Q is the Federal Reserve’s capital adequacy regulation. The FDIC and OCC have practically identical capital adequacy regulations under 12 C.F.R. Parts 324 and 3, respectively). Under Regulation Q, the largest U.S. banks are subject to a capital methodology known as the “advanced approach,” whereas smaller banks are subject to the so-called “standardized approach.” The capital relief strategies described in this article are available under both approaches.

[3] RWAs will generally include all assets owned by a bank. For purposes of determining the risk-weighted amount of an RWA, the amount of the RWA will be subject to a risk multiplier (or “risk weight”). In general, RWAs that regulators believe to be low risk will have lower risk weights (and therefore less associated risk-based regulatory capital), and RWAs that regulators believe to be high risk will have higher risk weights (and therefore a greater amount of associated risk-based regulatory capital).

[4] Participation structures can also be used for capital relief, and can be either bilateral or multilateral.

Cadwalader Webinar Series: A Practical Guide to Capital Relief Trades for U.S. Banks

Cadwalader's financial services team is hosting the first of a four-part series focused on capital relief trades, where attorneys will discuss the nuts and bolts of these transactions, which a growing number of U.S. banks are exploring to optimize regulatory capital and manage credit risk, including capital benefits, structural considerations and other legal and regulatory issues. The first installment, on Wednesday, June 22 at 1 p.m., will feature partners Jed Miller, Daniel Meade and Ivan Loncar on the topic, "CRT Overview and Regulatory Capital Basics."

You may register for the webinar series here.
