# Capital Optimisation & Credit Risk Mitigants

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**Lorna Strong, HSBC**
**Nate Hummel, Allianz Trade**
**Michael Avidon, Moses & Singer**

# What are the drivers of capital optimisation for banks?

Changes have arisen in the operating environment after the 2008 financial crisis:

- new regulations on capital adequacy
- enhancing supervision and risk management within the banking sector
- Ring-fencing regulation

- In particular, new regulations (e.g. BASEL, CRDIV, CRR) require banks to bolster capital ratios and require institutions to hold more and a higher quality of capital. The intention is to make banks safer and less likely to fail as a result of excessive risk.

- The general principle is that a bank must maintain at all times financial resources equal to or greater than a percentage of its risk-weighted assets

# What are the drivers of capital optimisation for banks?

- There is a gap between returns on capital and the related cost of lending for banks. While the regulatory requirement to hold more capital has made banks safer, the cost for banks is greater but shareholder expectations for returns have not taken this into account.
- It is therefore increasingly important that the capital contribution of the bank to any lending is assessed as part of the profitability of the transaction, and this is *optimised*, where possible.
- The EU Capital Requirements Regulation (CRR), for example, requires a bank to satisfy certain own funds requirements by calculating the risk weighted exposure for each asset.
- Capital consumption for each asset is therefore measured on the basis of *Risk Weighted Assets.*

# What are RWA's and why are they important?

- Risk-weighted assets (RWA's) are a bank's assets or products (a loan, demand guarantee, discounted Letter of Credit, etc.) risk weighted according to the perceived risk of loss.
- The purpose of risk-weighting is to ensure that the regulatory capital required for any specific deal is in line with the actual risk profile of that deal.
- In accordance with applicable regulation RWA can be calculated using different methods.
- Regulators use the aggregate amount of RWAs across the bank to determine the minimum level of capital that needs to be held in order to absorb potential future losses.
- As total RWAs grows, so too does the level of capital that a bank is required to maintain, ultimately reducing shareholders' return and leaving the bank with less capacity to do more business and grow. Hence the need to reduce RWA's.

# ➢ What are some of the ways in which a bank can achieve capital optimisation?

- Reduction of RWA's can be achieved through a number of ways:
  - Reduction of RWA's through "*credit risk mitigation*"
  - Syndication of loans - sharing the risk in a loan via syndication with other FI's
  - Distribution of risk arising in a trade or loan deal via a *Master Risk Participation Agreement* (MRPA)
  - Securitisation of risk
  - Other options?

# Ways to achieve Capital Optimisation Differ

## Credit Conversion Factor (CCF) Method in the US

- In the US, the Credit Conversion Factor (CCF) method is used to convert off-balance sheet instrument (OBSI) exposure to on-balance sheet items such as swaps, guarantees, and LCs.
- CCF guidelines treat different deals differently. A commercial (documentary) letter of credit is typically set at 20%, a performance standby at 50%, and a financial standby at 100%. This is similar to outside of the US, but regulation dependent.

## Capital Requirement Relief Differences

- Non-US banks have the option to satisfy capital requirements through distribution or insurance.
- US banks, on the other hand, do not receive capital relief benefits from non-payment insurance.

## Business practices

- US Market can seem very binary, Banks deal in SBLCs and surety companies deal in Bonds
- Non-US markets it is commonplace for banks, sureties and non-banks to participate/syndicate guarantee and bond facilities

# What is Credit Risk Mitigation?

- Credit Risk Mitigation is a technique used by a bank to reduce the credit risk associated with an exposure

- The application of a *credit risk mitigant* reduces the risk weight (RWA) of the deal or the expected loss amounts.  In result, the bank is required to hold less capital for that deal.

- The regulations restrict the forms of credit risk mitigation to the following:

  - Forms that would be recognised under the applicable regulations, and

  - Instruments which are legally *effective and enforceable* in all relevant jurisdictions. They must be liquid, immediately enforceable, have no dependencies, and have clear triggers for payment.

- The regulations require this to be assessed and confirmed by way of an independent, written and reasoned legal opinion to be provided to regulators on request.

# Credit Risk Mitigants – funded and unfunded

- Credit Risk Mitigants can be divided into funded and unfunded.

- Funded credit risk mitigants / protection. These *may* achieve de-recognition and RWA savings/ improved return on RWAs (RORWA)
  - ✓ cash collateral, securities, immovable property collateral
  - ✓ "on balance sheet netting" of mutual claims between the bank and the counter-party)
  - ✓ funded risk participations

- Unfunded credit risk mitigants / protection. These provide a reduction of risk and *may* result in improved RoRWA)
  - ✓ Insurance policies, re-insurance
  - ✓ Export credit agencies protection
  - ✓ corporate guarantees (e.g. from parent or affiliate entity)
  - ✓ guarantees issued by central banks, governments, public sector entities
  - ✓ Unfunded risk participations

# Credit Risk Mitigants – funded and unfunded

- Risk participations/ distributions are typically done under a standard industry Master Risk Participation Agreement law (MRPA), with schedules for individual deals.
- There is a significant market in funded participations the US, particularly in Supply Chain Finance (SCF) and trade finance-backed securities. However, the market for unfunded risk participations is increasing.
- There's also a notable trend of seeking non-bank institutions to participate in funded facilities supporting receivables financing and supplier finance programs.
- There is an English law Master Risk Participation Agreement (MRPA) for unfunded participations, but not a NY law version. Is this needed?
- SBLCs are by their very nature unfunded obligations. What are the benefits and challenges in using an MRPA for unfunded instruments?

# Takeaways

- ✓ Capital optimisation is becoming increasingly important for banks.
- ✓ Captial optimisation is heavily regulated but is possible using certain structures.
- ✓ Legal opinions will be increasingly needed to confirm what can be treated as a credit risk mitigant.
- ✓ Risk participation agreements & methods to achieve capital optimization are industry standard, but vary in the US compared to the approaches for non-US parties.