GSE Activity Report

Monday, October 23, 2023

Spotting SPVs

Summary

As noted in our report earlier today, the Federal Reserve's latest financial-stability report expresses deep misgivings about complex securitizations. This flies directly in the face of its recent decision to liberalize the capital treatment for credit-linked notes involving bankruptcy-remote SPVs, yet more evidence that the U.S. has a central bank of many silos that interact infrequently, if at all.

Impact

As we said in our initial analysis of CLNs:

> banks can obtain capital credit via credit-linked notes if the note is issued by a bankruptcy-remote SPV which uses the cash proceeds from note issuance as collateral taken by the bank under terms applicable to other forms of collateral deemed eligible credit-risk mitigation under the capital rules governing synthetic securitizations in particular and CRM more generally. Interestingly, capital credit for credit-linked note collateral is possible even if the bank directly issues the note as long as terms of the credit derivative adhere to those otherwise required for credit-derivative capital recognition. However, notes that conform to standard documentation or are backed by a guarantee have a newly-cleared path to capital credit related to cash proceeds. The FAQs explain the Board's concerns and imply that satisfactory product design will win its heart.

In the financial-stability report, the Board observes that non-agency securitization markets are generally sound even when it comes to higher-risk commercial real estate. However, when it turns to bank exposures to nonbank financial intermediaries, the Fed notes a 25% YOY increase in bank exposures to NBFIs, largely due to exposures to securitization special-purpose entities. In a footnote regarding securitization, the report states that SPVs are higher-risk because they are generally highly-leveraged.

Where this all may come together is the requirement for cash collateral from the SPV to give the CLN note the capital regulatory staff's blessing. Theoretically and even actually, cash in hand trumps leverage even if there is also a nominal exposure to the counterparty equivalent to the cash. Thus, we do not expect any near-term reversal of the CLN ruling, but also doubt that any transaction structures involving CLNS or SPVs without a lot of upfront cash will advance.

Outlook

Another warning in the financial-stability report related to NBFIs pertains to credit lines such as those

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banks extend to nonbank mortgage companies. Here, the Fed observes relatively stable exposures, but still concludes that correlated drawdowns could put large banks under acute stress since current high-quality liquid asset balances would not suffice. We expect this issue to be reflected in pending revisions to the bank liquidity standards sparked by recent runs as well as the FSOC's forthcoming inquiry into the systemic risk posed by nonbank mortgage companies.

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