

Boosting Geographic Diversification of Bank Commercial Mortgage Loan Portfolios

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U.S. bank regulators are now targeting commercial real estate lending as an area for special scrutiny.¹ One important dimension of risk in commercial mortgage loan portfolios is geographic concentration. Except for the largest banks, most institutions have notable geographic concentrations in their commercial mortgage loan portfolios. The regulators should encourage banks to mitigate risk by boosting the geographic diversification of their commercial mortgage loan portfolios. Here is one way that would allow banks to do so.

The approach has two steps. In the first step, a bank sheds risk on its existing portfolio. In the second step, the bank acquires exposure to a geographically dispersed pool of commercial loans originated by other banks.

In the first step, the bank "buys protection" on a mezzanine slice of its own commercial mortgage loan portfolio. For example, the protection might cover losses that exceed 1.5% of the original balance of the loans, up to a maximum of 5.0%. Think of it as a credit loss insurance policy with a deductible of 1.5% and a coverage amount of 3.5% (*i.e.*, 5.0% - 1.5% = 3.5%). If the bank's commercial loan portfolio is \$1 billion, the swap might cover losses from \$15 million to \$50 million. However, instead of taking the form of an insurance policy, the protection likely would be a credit default swap or "CDS." In CDS jargon, the protection would have an "attachment point" of 1.5% and a "detachment point" of 5.0%. The bank would purchase the CDS from a securities firm that deals in CDS. For purposes of our example, we'll call the firm the "Swaps Dealer."

In purchasing credit protection through a CDS, a bank must balance competing considerations in selecting the attachment and detachment points. The attachment point should be substantially higher than the level of "expected losses" on the protected portfolio to keep the price of protection reasonable. A bank naturally knows its own loan portfolio better than outsiders do — it faces less uncertainty about the level of expected losses. Accordingly, each bank reasonably has the strongest bid (*i.e.*, ascribes the highest value) to the "first loss" exposure on its own loans. It usually cannot buy "first loss protection" at a price that it would deem fair. Thus, for a bank to buy protection economically through a CDS, the attachment point must be substantially higher than the level of expected losses.

Likewise, the detachment point on a CDS should be high enough that it covers most plausibly adverse scenarios (*i.e.*, high levels of unexpected losses), but not so high that it covers extremely unlikely "catastrophic" losses. Compared to third parties, a bank can better judge what is reasonable for its own portfolio. By properly selecting attachment and detachment points, the CDS contract can provide a bank with meaningful protection at a reasonable cost.

¹ Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, 71 Fed. Reg. 2302 (13 Jan 2006).

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In the second step, the bank takes exposure to commercial real estate loans backed by properties all over the country. The bank can do so by indirectly selling protection to other banks through an arrangement that pools together their risk. The Swaps Dealer from the first step repeats the process of selling protection to numerous banks all across the country. Thus, it becomes "long" the credit risk on a geographically diversified pool of mezzanine exposures from different banks. Then the Swaps Dealer pools those mezzanine exposures to create a structure in which the different banks can assume risk.

Many structures could be suitable. For example, the Swaps Dealer might pool the mezzanine structures to create a collateralized debt obligation or "CDO." A CDO is an arrangement that issues tranches at different levels of seniority. The banks could purchase mezzanine tranches and, possibly, equity tranches in the CDO. Those tranches would allow the banks to take on exposure to geographically diversified commercial real estate credit risk at attractive yields. The CDO's senior (or "super-senior") tranches could be purchased by other investors that have lower yield targets and lower risk tolerances.

This idea for helping banks improve geographic diversification of their commercial mortgage loan credit risk is reasonably straightforward. However, it requires a Swaps Dealer to sell protection and accumulate risk until there is a geographically diversified portfolio. Banks likely will benefit when Swaps Dealers start to provide such services.

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