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August 1, 2024

The Honorable Jerome Powell, Chair
Board of Governors of the Federal Reserve System
Constitution Avenue & 20th Street NW
Washington, DC 20551

Dear Chair Powell:

I write to request that the Federal Reserve place additional guardrails around "credit risk transfer" transactions (CRTs), which banks use to reduce capital requirements by offloading risk to private funds. I am concerned that CRTs may not be conducted in a safe and sound manner and that they may increase risk across the financial system.

According to press and industry reports, interest in CRTs has picked up considerably this year. U.S. banks of all sizes have executed around 20 transactions totaling an estimated $17 billion to cut capital charges on a variety of commercial and consumer assets, including cars, multifamily housing projects, private equity funds, and industrial equipment. According to an analysis by ratings agency S&P, a record number of U.S. banks are engaging in CRT transactions. Rapid growth is expected to continue. For example, BlackRock has predicted that U.S. issuance could grow by 30% to 40% each year for the next two years, citing "crucial regulatory guidance [from the Federal Reserve] late last year."

As the size of this market has grown, so too have the sophistication of these instruments and the associated risks to the banking system. Most notably, these transactions are becoming leveraged. According to analysts, most investors in CRTs are borrowing money—often from a Wall Street bank—to finance their investments. Investors can borrow up to 60% of the funds for an investment. If riskier loans in CRTs fail at the same time, then banks that lent this money may not be repaid or could be repaid in illiquid securities. In that situation, risks would come crashing back to the banking sector and losses would ripple through the financial system more broadly.

Further, the use of bank-provided leverage raises serious questions about whether CRTs truly transfer credit risk to outside investors or further concentrate risk among a small number of Wall Street banks. According to reporting by *Reuters*, recent CRTs "hark back to some of the complexity and opacity of financial products such as collateralized debt obligations that were blamed for exacerbating the 2008 crisis." The return of these transaction structures "shows how some Wall Street practices from the time, which proved to be problematic as they dispersed risk in ways that were not fully understood, are coming back, albeit in new wrappers."

Without a full understanding of the data and risks associated with CRTs, I am concerned that widespread efforts to avoid stronger capital and regulatory requirements put in place as a response to the 2008 crisis could expose the financial system to new risks. These concerns are especially acute because banks are not required to disclose any information regarding CRTs.

I, therefore, request that the Federal Reserve:

1. Require public regulatory reporting (through bank call reports and systemic risk reports) of information regarding each bank's use of CRTs, including the amount of risk transferred, the associated capital relief, the identities of the counterparties, the amount of risk transferred to each counterparty, and the credit quality of assets in each reference pool.

2. Establish quantitative limits on banks:

    a. Using CRTs to reduce capital requirements—both in the aggregate and by counterparty.

    b. Treating CRT proceeds as unrestricted cash, which can be used to pay dividends or buy back stock.

    c. Providing leverage to nonbanks to use in connection with CRT investments.

3. Ensure that the stress testing methodology expressly considers the different ways that risk purportedly laid off through CRTs could affect the banking system in an economic downturn or financial crisis, such as decreased lending capacity by banks that have issued CRTs and default risk for banks that have financed CRTs.

4. Update its response dated March 7, 2024 to my letter dated November 30, 2023 with an assessment of the risks associated with CRTs based on supervisory experience to date, including an analysis of whether CRT instruments have truly laid off credit risk and are working as intended.

Thank you for your attention to this matter, and I look forward to your prompt reply.

Sincerely,

Jack Reed
United States Senator

cc: Hon. Janet Yellen, Secretary of the Treasury
Hon. Michael Barr, Vice Chair for Supervision, Board of Governors of the Federal Reserve System
Mr. Michael J. Hsu, Acting Comptroller, Office of the Comptroller of the Currency
Hon. Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation