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Reg Cap: Growing Private Credit Opportunity for Partnership With Banks

January 2024

Executive Summary

Private Credit vs. On-Balance Sheet Bank Lending

Private credit, a term that encompasses various types of lending by asset managers, has grown dramatically in recent years, crowding out banks in certain areas. Banks are hampered by business challenges compounded by increasingly restrictive regulations. Rising interest rates have caused substantial losses on long-term fixed-rate assets held by banks, triggering the failure or forced merger of Silicon Valley Bank ("SVB"), Credit Suisse, First Republic Bank, and several others in March, 2023. See Section I, p.2.

Banks Use Reg Cap Transactions to Bolster Capital

At Seer we respect banks' longstanding client relationships and disciplined credit processes, and we generally prefer to work with banks on an incentive-aligned basis rather than compete against them. As a result, we have long been an active investor in regulatory capital relief ("reg cap") trades, in which banks purchase credit insurance against a defined quantum of credit losses on a specific portfolio of assets to reduce the regulatory capital they are required to hold against the portfolio. US regulatory uncertainty in recent years has helped make reg cap a primarily European product. See Section II, p.4.

US Regulatory Changes to Boost Use of Reg Cap Trades

In July, US regulators responded to pressure on the banking system with a proposal for significantly tighter capital rules to "make banks safer" and conform US regulations to international standards. In September, US regulators clarified the treatment of reg cap trades, offering banks an avenue for much needed relief. See Section III, p.9.

US Reg Cap Issuance Poised for Dramatic Expansion

US issuance is already gaining momentum, led by the largest banks, who stand to be the most negatively impacted by the new capital regulations. Issuance is expected to percolate down to regional banks, who have appetite to issue reg cap but will need more lead time to complete first deals. Given the size of the economy and banking system, US issuance is likely to dwarf the current market and create a multitude of compelling investment opportunities to complement growing European and Canadian bank issuance. See Section IV, p.13.

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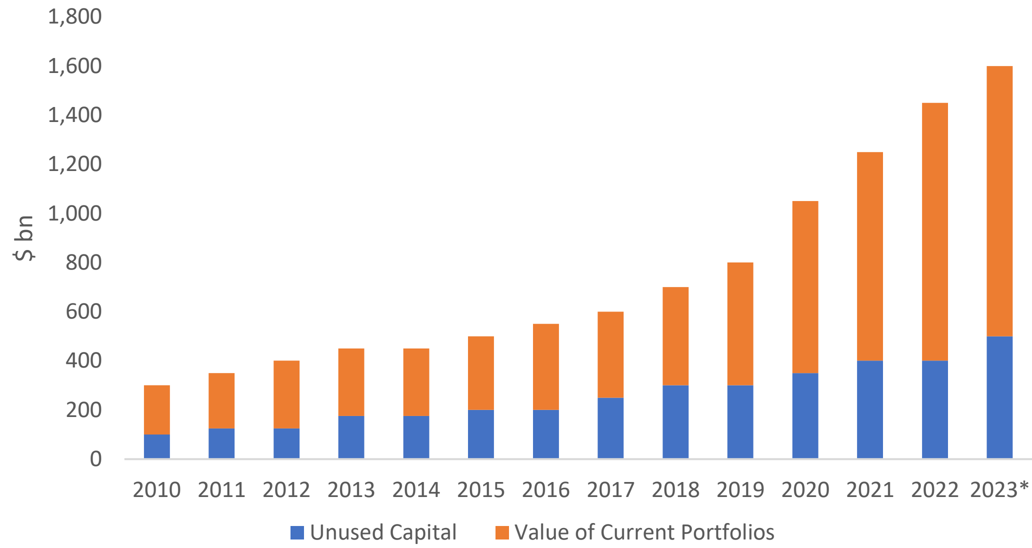
I. Private Credit vs. On-Balance Sheet Bank Lending

Private credit has grown explosively in the last few years, becoming a major asset class for large asset managers and their global allocator clients.

Figure 1: Private Credit Growth



** 2023 through March. Source: Bloomberg*

Private credit investors can work in partnership with banks, taking advantage of banks' client relationships and infrastructure to grow lending in a prudent and constructive way

Private credit encompasses a range of products and is touted by some as a replacement for bank balance sheet lending and a safer and more efficient way of delivering credit to the economy. On the other hand, journalists, regulators, and even industry participants have expressed concerns about a bubble and warned of contagion when it inevitably bursts. At Seer we believe the truth lies somewhere in between, as is usually the case. Asset managers armed with significant new capital are motivated to deploy it, which is bound to stimulate development of creative new products, some of which will prove to be poor investments. However, using a long existing product, private credit investors can work in partnership with banks, taking advantage of banks' client relationships and infrastructure to grow lending in a prudent and constructive way.

The growth of private credit has been accelerated by challenges faced by banks, highlighted by the failure of Silicon Valley Bank ("SVB") and the subsequent rescues of Credit Suisse and First Republic in March, 2023. The failures were triggered by concerns about unrealized losses on long-term fixed-rate securities, spurring depositors to withdraw funds at an unprecedented rate. Many banks face a mismatch between short-term deposit liabilities and long-term assets and are subject to stress when interest rates rise, as they did rapidly in early 2023. For more on the turmoil of March, see https://seercap.com/wp-content/uploads/2023/04/Bank-Turmoil-Creates-Compelling-Opportunities-in-Reg-Cap.pdf.

Following the March events, deposits flowed out of all but the largest banks, mostly in search of higher returns from money market funds. Banks continued to suffer losses on unhedged long-term fixed-rate assets accumulated in a lower interest rate environment. Many banks also face potential losses from exposure to commercial real estate. Commercial property has declined in value due to higher interest rates, and office properties in particular have suffered due to lingering behavioral changes post-pandemic.

Locked-up private capital is thought to be a better funding source for long-term loans, particularly loans at the riskier end of the credit spectrum which are highly capital intensive for banks to hold. Banks are under pressure to find alternative means to shore up their capital base or distribute credit risk associated with their lending activities. Some banks have sought to establish direct lending partnerships with asset managers, with the banks providing access to clients and the asset managers providing risk capital. At Seer we are concerned about possible misalignment of interests in such arrangements.

The table below explores Seer's approach to some key private credit businesses.

	Direct Lending	Asset-Backed Lending
Description	Lending to levered companies, in many cases for buyouts. Often lower in credit quality than leveraged loans, with high leverage, limited operating history, and concentrated in specific industries.	Acquisition of portfolios of loans from originator, and or Establishment or acquisition of lenders, usually consumer lenders
Seer perspective	Cautious about how lending to highly levered borrowers, which has expanded rapidly, will perform over a credit cycle.	Cautious about acquiring portfolios or business that banks wish to exit, and Cautious about alignment of interest and lender incentives to maintain credit discipline rather than maximize origination volumes.
Seer approach	We are securitized products, rather than corporate credit, analysts. We rely on diversification, structure, and performance history rather than views on single credits. We see BB and BBB tranches of CLOs, with credit protection afforded by junior CLO equity investors, as a more attractive way to play the levered credit space. These tranches offer spreads in the mid-high single digits, commensurate with direct lending, but provide well protected exposure to diversified portfolios of loans to what we believe to be better quality borrowers. *	In 2015 we founded Home Express Mortgage to fill a gap in the non-agency mortgage lending market which persisted following the financial crisis. We backed a skilled and experienced management team that has established a disciplined origination machine, selling production at regular auctions to the most competitive bidder, whether Seer or otherwise.

**For more on CLO mezzanine tranches see https://seercap.com/wp-content/uploads/2021/10/Seer-Capital-Reg-Cap-vs.-CLO-BB-Rel-Val-Research-Piece.pdf*

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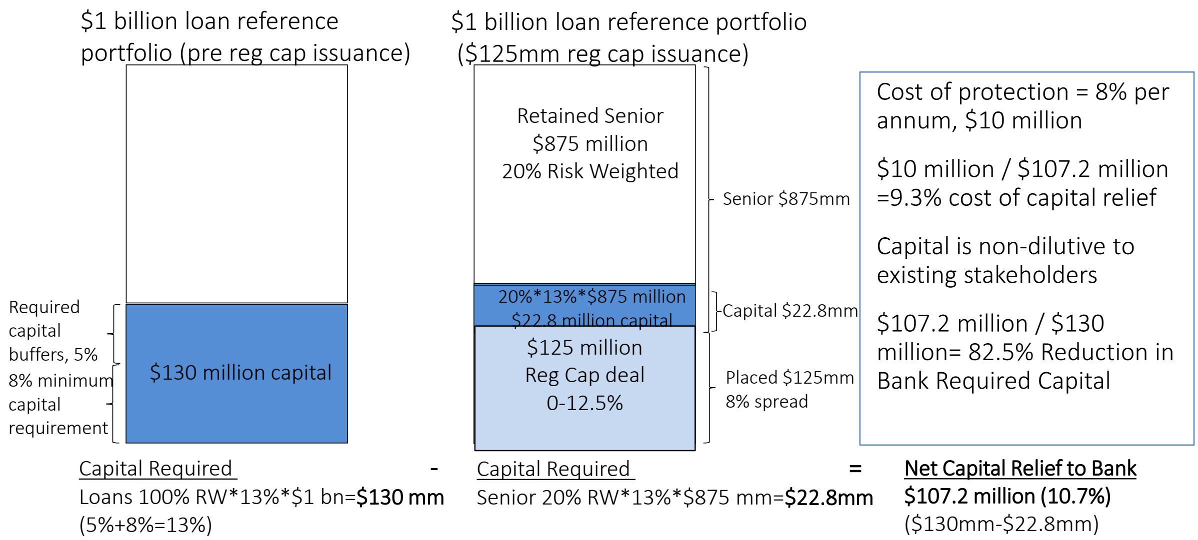
II. Banks Use Reg Cap Trades to Bolster Capital

Reg cap trades are i) an attractive investment opportunity and ii) an important tool to support rational, measured credit growth

The reg cap market is an emerging area within private credit that Seer believes represents i) an attractive investment opportunity and ii) an important tool for banks to support rational, measured credit growth. In reg cap trades, private credit investors are paid to assume a tranche of credit risk on a specific portfolio of a bank's assets, which reduces the regulatory capital the bank must hold against those assets. Investors work symbiotically with banks, generating attractive risk/reward profiles while helping banks grow their business profitably within their core competency.

Figure 2: Structural Diagram of Typical Reg Cap Trade



Banks employ large teams of originators who maintain longstanding relationships with borrowers, often in specific local markets, as well as large credit and compliance teams to ensure that lending is done carefully, consistently, and in accordance with complex regulations. Many banks are constrained from taking full advantage of their lending franchise to originate profitable loans because they lack sufficient capital. This effect is magnified by regulators, who are continually making capital rules tighter and more complex.

Because banks issuing reg cap are motivated by capital relief more than risk relief, they are willing to pay a higher premium than is justified by the credit risk transferred

Reg cap transactions can provide banks with capital that is more cost effective than alternative sources, enabling banks to lend profitably to their core clients at cheaper rates. Because issuing banks are motivated by capital relief more than risk relief, they are willing to pay a higher premium than is justified by the credit risk transferred.

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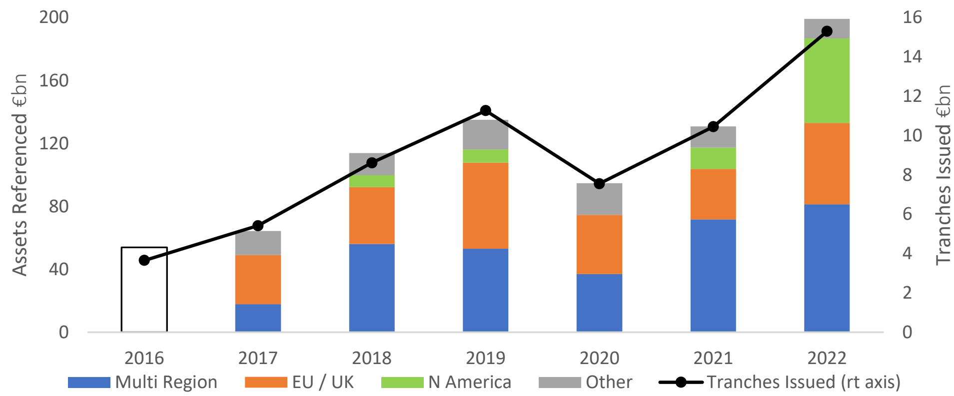
Global Reg Cap Market – Growth Drivers

Reg cap trades have become an essential tool for banks globally, especially in Europe. In 2022, a total of €15.3 billion of risk was distributed, referencing €199.1 billion of assets. 2023 likely represented an increase on that, although totals are still being tallied.

European banks have historically been the largest issuers of reg cap, but US issuance stands to grow significantly

Figure 3: Reg Cap Market Growth



Source: IACPM

The bulk of the assets referenced in reg cap deals have been multi-regional or EU / UK, as European banks have accounted for the largest share of issuance. More North American assets were referenced in 2022 due to a combination of (i) a smattering of issuance from US banks in spite of regulatory uncertainty (see below), (ii) an increase in issuance from Canadian banks (2023 saw much more issuance from north of the border, also see below), and (iii) inclusion of North American assets in reference portfolios from European and other banks. Note, data on US issuance was not available for 2020.

European banks have been the largest issuers because many generate below market ROE and trade at a discount to book value, making it dilutive for them to raise equity capital.

Figure 4: Price to Book and ROE of Large Banks

Source: Bloomberg, as at 1/8/2024

The market has grown because banks achieve numerous important benefits from reg cap trades.

Benefit	Description
Manage Capital	• Meet increasing regulatory capital standards • Release capital from low ROE or capital intensive businesses • Raise capital against asset portfolios with high regulatory capital requirements relative to the underlying credit risk • Create value by raising capital to buy back shares at a discount
Manage Risk	• Reduce credit loss provisioning volatility • Manage exposure to large clients • Manage exposure to specific business lines or sectors
Support Lending	• Demonstrate ability to distribute risk • Establish capital market benchmarks for the cost of lending / capital • Free up capital allocated to key clients and businesses

Regulatory evolution toward higher capital requirements drives reg cap issuance growth. Global banking standards are established by the Basel Committee on Banking Supervision, a committee of the Bank for International Settlements ("BIS"), and then implemented by banking regulators in each jurisdiction. The latest Basel standards, sometimes referred to as "Basel IV", were first announced in 2017 to be phased in starting in 2023. The standards include a floor ("output floor") on the calculation of risk-weighted assets ("RWA") based on the standardized approach, which applies a 100% risk weighting to most loans, even for banks approved to calculate RWA based on their internal risk models ("IRB approach"). For more on the RWA calculations and the standardized vs IRB approach, see https://seercap.com/wp-content/uploads/2021/02/Seer-Capital-Bank-Regulatory-Capital-Relief-White-Paper-Feb-2021.pdf.

New global bank capital standards, by reducing reliance on bank internal risk models, can incentivize banks to include less risky assets in reg cap transactions

The output floor, which sets minimum RWA at 72.5% of the standardized approach by full phase in in 2028, is expected to increase overall RWA for many banks. The RWA floor is billed by regulators as a way to limit banks' discretion to determine how much capital they hold against their loans, but many market participants view banks as better judges of risk than a blunt regulatory formula. In any event, the floor creates interesting opportunities for reg cap investors by i) adjusting the relative risk weights for different assets, leading banks to issue reg cap transactions backed by different portfolios, including more consumer assets, and ii) incentivizing banks to include higher credit quality assets in reference portfolios, since higher credit quality assets attract more capital under the standardized approach vs the IRB approach, while lower credit quality assets may attract less capital under the standardized approach.

As Figure 5 illustrates, when regulators move from the IRB approach to the standardized approach, banks are motivated to include less risky assets in reg cap deals to achieve maximum capital benefit at lowest cost.

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Figure 5: Standardized vs IRB Capital for Assets with Different Risk Profiles

Rating[1]	One-year Default Probability	Risk Weight (Standardized)	Risk Weight (IRB)[2]	Capital Required (Standardized)[3]		Capital Required (IRB)[3]		Capital Difference
BBB+	0.1%	100%	26.4%	13%	-	3.4%	=	**9.6%**
BB+	1.0%	100%	82.1%	13%	-	10.7%	=	**2.3%**
BB-	3.0%	100%	114.2%	13%	-	14.8%	=	**-1.8%**

[1] Moody's rating corresponding to 1 year default probability. [2] Source: BIS. [3] Assumes 8% capital + 5% buffers.

Assets where the capital treatment diverges from the risk profile are ideal for inclusion in reg cap transactions because banks have the appetite to pay significant spread premia for capital relief, while investors assume limited credit risk

Increasingly onerous and complex capital regulations invariably create pockets of assets on bank balance sheets where the capital treatment diverges from the actual risk profile. These assets are ideal for inclusion in reg cap transactions because they provide a "win/win" for investors and banks—banks have the appetite to pay significant premia to investors for capital relief, while investors assume limited credit risk.

Market growth is self-fulfilling. Issuing a first time reg cap deal requires considerable effort and internal coordination, especially for banks below the largest tier. Data needs to be gathered, internal accounting and regulatory treatment need to be developed, portfolio selection and reporting procedures need to be implemented, and information needs to be prepared and distributed to investors. Once a bank has completed an inaugural transaction, repeat issuance is much easier (and more affordable due to the amortization of program setup costs.) What makes sense for one bank often makes sense for similar banks, so reg cap issuance tends to spread from one bank to others in specific jurisdictions and from larger banks to smaller banks. Indeed, banks globally face increasing competitive pressure to take advantage of reg cap issuance to optimize capital and balance sheet deployment.

As the reg cap market has grown, the range of assets and risks distributed has grown commensurately. Below is a non-exhaustive list of asset classes that have been referenced in reg cap deals:

Agricultural Loans	Emerging Market Loans	Project Finance Loans
Auto Leases	Large Corporate– IG	Residential Mortgages
Auto Loans	Large Corporate– Crossover	Residential Mortgages-- High LTV
Capital Call Facilities	Large Corporate-- Disclosed Names	Small Ticket CRE Loans
Commercial Real Estate Loans	Leveraged Loans	SME Loans-- Mid Cap
Consumer Loans	Non-Performing Loans	SME Loans-- Small Cap
Counterparty Exposures	Object Finance Loans	Trade Finance

At Seer, we prefer transactions backed by granular portfolios to which we can apply a statistical approach to predict asset performance

At Seer, we prefer transactions backed by granular portfolios to which we can apply a statistical approach to predict asset performance, relying on historical performance of similar assets originated by the bank. Seer prefers "off the run" assets rather than corporate loans and these assets have accounted for a significant share of the market growth in recent years. "Off the run" assets are more likely to come from pockets of a bank's balance sheet where the regulatory treatment diverges from the risk profile. Many reg cap investors are corporate credit analysts and invest in reg cap deals to acquire exposure to specific corporate credits. These investors tend to assume junior risk against portfolios with significant concentration to one or a handful of credits, which Seer generally finds less attractive than deals backed by more diverse portfolios.

Reg Cap in Canada

Canada, which became a significant contributor to global reg cap issuance in 2023, is an instructive case study in market growth. Bank of Montreal ("BMO") has been a longstanding issuer of reg cap deals, with issuance programs referencing a variety of asset classes, including SME loans, leveraged loans, small ticket CRE loans, etc. BMO had outstanding reg cap transactions referencing CAD 61.2 billion of loans as at 10/31/23, up from 40.3 billion as at 10/31/22, versus total assets on balance sheet of CAD 1.3 trillion. In 2023, four other Canadian banks issued reg cap deals, driven by (i) an increase in the Domestic Stability Buffer added to the minimum required capital ratio from 2.5% to 3.5%, (ii) Basel output floor as described above, and (iii) capital required for M&A activity. At least three of the issuers are known to be contemplating repeat issuance. Canada's banking system is extremely concentrated--85% of the banking industry's assets are held by the top 5 banks. These top institutions have the scale and operational ability to develop a reg cap issuance program quickly when conditions dictate.

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III. US Regulatory Changes to Boost Use of Reg Cap Trades

Historically, Citibank has been a regular reg cap issuer, JP Morgan has issued periodically, and Goldman Sachs has joined the fray selectively. Fannie Mae and Freddie Mac, government sponsored enterprises that guarantee credit risk on US mortgages, transfer significant volumes of that risk to investors using reg cap technology. However, for the past several years, regulators have prevented most US banks from issuing reg cap deals. A few regional banks completed deals, apparently with approval from regional Federal Reserve banks, but larger banks could not obtain capital relief. Santander issued several deals referencing US auto loans and mortgages, but these were aimed at capital relief at the non-US parent level. For more on the regulatory regime that prevailed see https://seercap.com/wp-content/uploads/2022/08/US-Banks-to-Fuel-Significant-Growth-in-Reg-Cap-Issuance.pdf.

Figure 6: Reg Cap Issuance by US banks, 2021-mid 2023

Bank	Deal	Reference Assets	Portfolio Size (USD bn)
Merchants Bank	MBHC 2023-CL1	CRE Bridge Loans	1.1
Western Alliance	2022-CL4	Resi Mortgage	1.9
PacWest	2022-1	Resi Mortgage	2.7
Merchants Bank	2022	Multifamily Bridge Loans	1.2
Western Alliance	2022-CL1	Resi Mortgage	3.9
Western Alliance	2022 (Corp Issuance)	Cap Call Facilities	2.2
Western Alliance	2021-CL2	Resi Mortgage	4.6
Western Alliance	2021-CL1	Mortgage Warehouse	1.9
Texas Capital	2021-CLN	Mortgage Warehouse	2.2

Source: Santander, Bloomberg

New Proposed Capital Regulations for US Banks

At the end of July, 2023 US regulators announced their proposal ("Basel Endgame Proposal") to conform US capital regulations to the Basel standards. Regulators framed the proposal as a way to make banks safer in the aftermath of SVB and the ensuing turmoil earlier in the year. The proposal set forth by the OCC, the FDIC, and the Federal Reserve in a dense 1087-page document (one law firm produced a *summary* that ran to 243 pages) applies to banks with over $100 billion of assets.

Capital calculations would be overhauled completely, with the IRB approach replaced by an adjusted version of the standardized approach billed as the "expanded risk-based approach." Banks with over $100 billion in assets would be required to include unrealized gains and losses in their Available for Sale securities portfolios in capital calculations (in response to SVB). The proposal would apply from June 30, 2025, subject to a three-year phase in from that date. Even absent the proposal, all US banks are already subject to an RWA floor at 100% of the standardized approach due to the Collins Amendment to the Dodd Frank Act (in the rest of the world, the 72.5% output floor is being phased in).

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"We want a safe banking system. There's no question about it. We want safe cars driving on highways too, but we don't make a choice to have them driving 10 miles an hour, because that would reduce freedom of movement. It would devastate the economy."
-Robin Vince, CEO of BNY Mellon, on new proposed US capital regulations

Large banks and others are working to convince regulators to modify the Basel Endgame Proposal, arguing that it would constrain lending and increase costs for businesses. Robin Vince, CEO of Bank of New York Mellon Corp, said, "[W]e want a safe banking system. There's no question about it. We want safe cars driving on highways too, but we don't make a choice to have them driving 10 miles an hour, because that would reduce freedom of movement. It would devastate the economy." JP Morgan Chase CEO Jamie Dimon is also a vociferous opponent of the proposal, arguing that it will accelerate the transfer of lending from banks to unregulated private credit.

The proposal will impact the development of the reg cap market in the following ways:

	Impact	Illustration
1	Overall capital requirements will increase substantially, especially at large banks, creating more need for capital relief.	Figure 7,8
2	Assignment of risk weights to different asset classes and business will be completely overhauled, meaning banks will need to review the capital requirements vs risk profile for each business. They will identify new pockets of assets where the capital requirement is substantially higher than the fundamental credit risk. Such assets are particularly attractive targets for reg cap issuance.	
3	The current form of the proposal substantially increases the amount of risk that a bank needs to sell in a reg cap transaction to obtain optimal capital treatment on the retained senior tranche.	Figure 9

While the proposal would not increase minimum required capital ratios, regulators estimate that it would increase the amount of capital large banks are required to hold by an estimated 16% overall by increasing the calculation of RWA applicable to their businesses. The rule would have a larger impact on trading activities than on lending and would have the largest impact on globally systemically important banks (GSIBs).

Figure 7: Projected Impact of Basel Endgame Proposal on Capital at Selected Large US Banks

		Current		Assuming Basel Endgame Implementation		
Bank	Total Assets ($bn)	Minimum Required CET1 Ratio	3Q'23 Surplus ($bn)	Estimated RWA Increase	Increase in Required Capital ($bn)	Pro-Forma Surplus ($bn)
JPMorgan	3,898	11.9%	40.5	30%	60.4	-20.0
Goldman Sachs	1,577	13.0%	12.2	35%	30.3	-18.1
Citigroup	2,368	12.3%	14.9	19%	26.8	-12.0
Morgan Stanley	1,169	12.9%	11.9	40%	22.9	-11.0
Bank of America	3,153	10.0%	31.0	20%	32.6	-1.6
State Street	284	8.0%	3.6	13%	1.2	2.4
BNY Mellon	405	8.5%	4.6	8%	1.0	3.6
Wells Fargo	1,909	8.9%	26.1	19%	20.9	5.1
Total	14,673		144.8		196.1	-51.6

Source: Bloomberg

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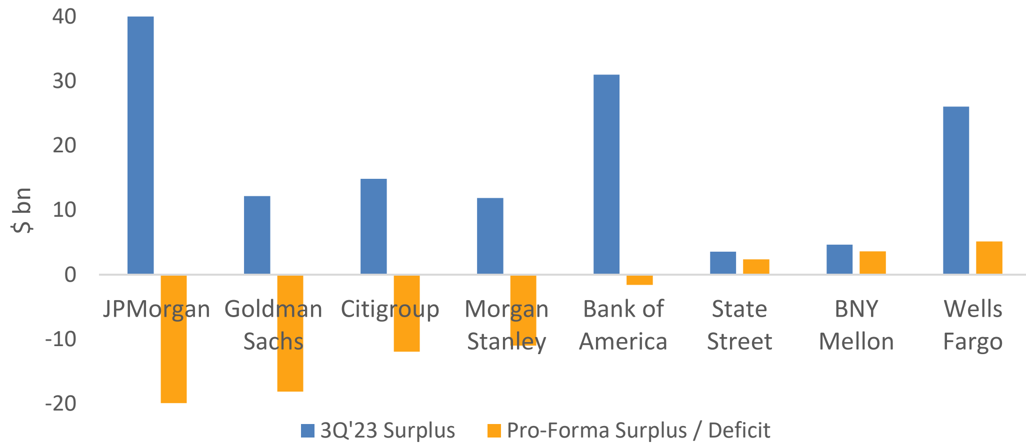
Figure 8: Change in Surplus Capital due to Basel Endgame Proposal, Selected Large US Banks



Source: Bloomberg

Reg cap transactions provide capital relief to banks by replacing the risk weighting on the pool of assets with the risk weighting of the retained senior tranche of the reg cap deal, see Figure 1. The Basel Endgame proposal would increase the "p-factor," a regulatory constant that is a multiple in the formula for risk weighting of the senior tranche, from 0.5 to 1.0. For a reg cap deal referencing a portfolio of 100% risk weighted assets, this would increase minimum enhancement to achieve optimal risk weighting on the retained senior to 25.5%, more than double the current minimum enhancement, see Figure 9 below.

Figure 9: Minimum Risk Weight and Enhancement to Retained Senior Tranche of US Reg Cap Deal

Item	Current	Proposed
p-factor	0.5	1.0
Risk weight of underlying assets	100%	100%
Minimum risk weight of senior tranche	20%	15%
Minimum enhancement to senior tranche	12.5%	25.5%

Source: Seer Capital Research

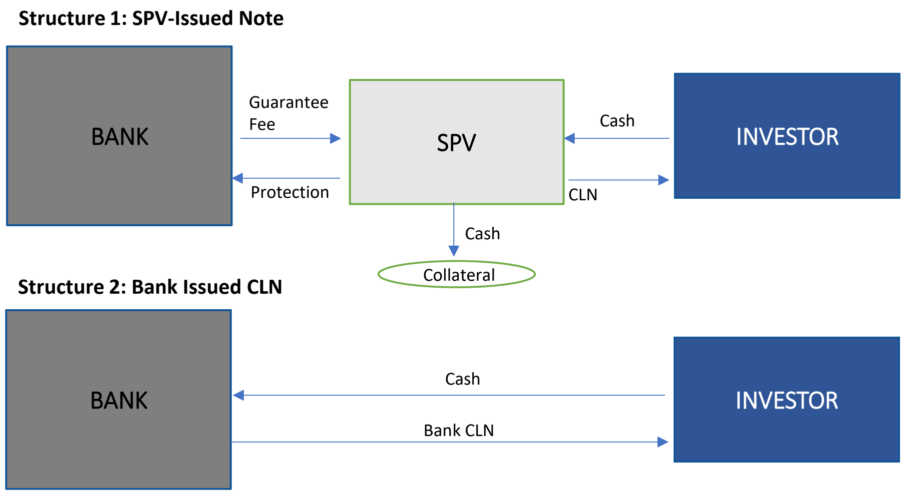
Either (i) US regulators will need adjust the formula to reduce credit enhancement required for optimal capital treatment for the retained senior tranche of reg cap deals, or (ii) a deep and affordable market for mezzanine risk will need to develop

European regulators recently settled on a p-factor of 0.5 in response to input from banks and other reg cap market participants. Either the US regulators will need to follow suit, or a deep and affordable market for mezzanine risk will need to develop if US banks are to rely significantly on reg cap. Interested parties were due to submit comments on the Basel Endgame Proposal by January 16, 2024, and implementation is expected in 2H 2024.

Fed Clears Path for Reg Cap Issuance

Some market participants were disappointed that the Basel Endgame Proposal did little to address the regulatory treatment of reg cap transactions. They were more satisfied at the end of September, 2023 when the Fed released Frequently Asked Questions ("FAQ") clarifying that reg cap deals are allowed under the current capital regulations. The Fed made the distinction between SPV structures, which do not require specific approval, and CLN structures, which require approval but which the Fed indicated they are disposed to approve (see Figure 10 below).

Figure 10: Reg Cap Structural Alternatives



The table below describes each of the structures and highlights the benefits and drawbacks.

	1. SPV-Issued Note	2. Bank Issued CLN
Description	SPV (special purpose vehicle) issues CLN and sells credit protection to the bank on the reference portfolio.	Bank issues CLN (credit-linked note) off its balance sheet, credit linked to reference portfolio.
Collateral	The SPV generally places the note proceeds on deposit with the bank. In some cases the SPV may place the deposit at a third party with a higher credit rating or invest in government securities.	The CLN investor is typically a creditor of the bank, but the bank may place the note proceeds in a segregated account to protect the investor from insolvency of the issuing bank.
Regulatory Status	Fed FAQ of September 2023 confirmed that banks can obtain capital relief by purchasing protection from an SPV which holds the proceeds of the notes as collateral for the CDS.	Fed FAQ of September 2023 indicated that CLN structure does not strictly comply with current capital regulations, however the CLN structure may be substantially similar to the SPV structure and banks may apply for approval to issue CLN.
Additional Factors	SPVs may be treated as Commodity Pool Operators and subject to CFTC regulation, EXCEPT where the underlying creditors are corporations and the pool can be replenished. For other cases, third party service providers may be able to assume the obligations to the CFTC. SPV structure introduces an additional counterparty / additional costs and complexities for an issuing bank, but may be easier than seeking Fed approval for CLN.	Issuers must obtain a reservation of authority from the Fed to claim capital relief for CLN. CLN structure currently preferred for consumer assets and non-replenishable portfolios of corporate assets due to CFTC regulation impacting SPVs. CLN structure exposes investor to more credit risk to the issuing bank, although this can be mitigated by segregated account structure.

IV. US Reg Cap Issuance Poised for Dramatic Expansion

The Fed FAQ touched off discussion and press coverage anticipating massive issuance of reg cap by US banks. For the first time, the product captured significant constructive attention from outlets such as the *Wall Street Journal*, *Financial Times*, and *Bloomberg*. Heretofore, press coverage had been limited, simplistic and uninformed, along the lines of "Banks Conspire to Issue Complex Derivative Products in Rehash of the Great Financial Crisis." An initial wave of deals has been completed by banks that had been preparing them in advance of the Fed announcement, as shown in Figure 11.

Figure 11: Recent US Reg Cap Transactions

Bank	Structure	Reference Assets	Portfolio Size (USD bn)
US Bank	CLN	Auto Loans	2.5
US Bank	SPV	IG Corporate Loans	5.0
JP Morgan	SPV	European HY Loans	2.0
JP Morgan	SPV	Large Corp Revolvers	[25]
Morgan Stanley	CLN	Capital Call facilities	[2.5]

Source: Bloomberg, Seer Capital Research

The considerable hype around the Fed announcement has prompted many new investors to seek exposure to US reg cap deals. Some of the deals in Figure 11 priced at tight levels relative to recent prints from global issuers, as large private credit investors sought to enter the space. This demand will be absorbed as the US market comes fully online in the medium term.

Alternative: Loan Sale

Reg cap is preferable to loan sales because i) banks typically sell portfolios to exit a business line, while reg cap investors participate in an ongoing lending business of a bank, and ii) issuers seeking capital relief for loans originated in a lower interest rate environment would need to recognize a loss on sale of a portfolio

Before and after the regulatory clarification, some US banks have solved capital problems by disposing of portfolios outright, in some cases with seller financing attached. An investor buying a seller financed portfolio assumes a levered position similar to a reg cap investor. However, banks typically sell portfolios to exit a business line, while an important selling point for reg cap investors is the opportunity to participate in an ongoing lending business of a bank. Also, issuers seeking capital relief for loans originated in a lower interest rate environment would need to recognize a loss on sale of a portfolio, which will prevent many banks from pursuing this option.

Figure 12: Recent Portfolio Disposals

Seller	Assets	Size	Date	Acquirer
PacWest	Consumer loans, timeshare loans, mortgages	$3.5 billion	June 2023	Ares
US Bank	Prime auto loans	$8 billion	June 2023	Bayview
Truist	Student loans	$5 billion	June 2023	N/A
Synovus	Prime auto loans	$373 million	August 2023	KKR
Bank of Montreal	Prime RV Loans	$7.2 billion	December 2023	KKR

Source: Bloomberg

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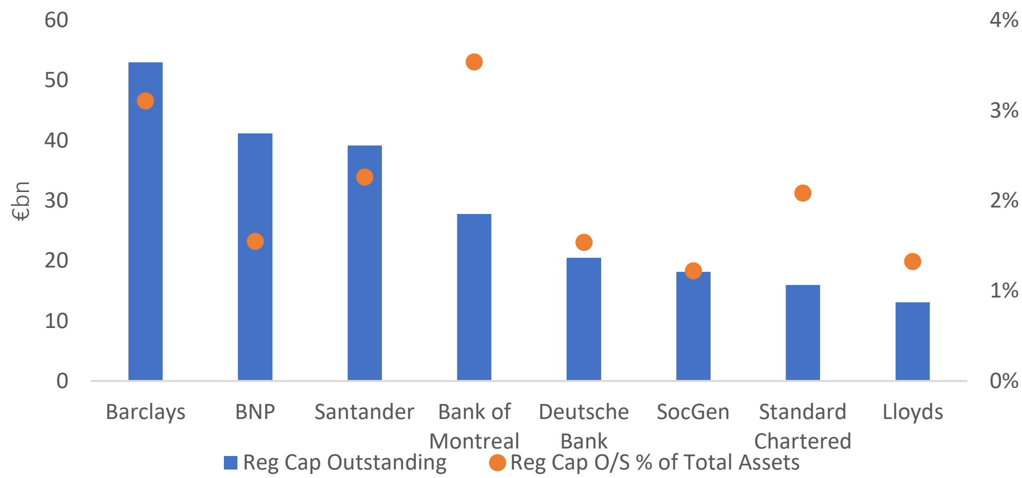
Projecting the Size of the US Reg Cap Market

As noted above, reg cap transactions can be complicated to execute, particularly for smaller first-time issuers. We expect US issuance to grow considerably from the initial wave in 4Q 2023, as institutions that awaited "proof of concept" come online. While relative pricing suggests that demand for reg cap deals outstripped supply as at the end of 2023, we anticipate significant supply in the next 12-18 months that will absorb current demand and more. Our projections begin with the percentage of total assets on balance sheet that a typical issuer might reference across all transactions in a reg cap program. The chart below shows assets protected in outstanding reg cap deals by some leading global reg cap issuers, who have purchased protection on between 1.2% and 3.5% of their total assets.

Figure 13: Reg Cap Outstanding by Leading Issuers



Source: Company Filings, as at year end 2022

If we consider all US banks with over $10 billion of assets as possible candidates for reg cap issuance, we include 132 institutions with over $23 trillion of assets.

Figure 14: Breakdown of US Banks by Total Assets

Size ($ bn)	Number of Banks	Total Assets ($ bn)
1,000+	6	14,075
500-100	3	1,768
200-500	10	2,970
100-200	9	1,445
50-100	12	887
10-50	92	2,127
10+	132	23,272

Source: Bloomberg (for total assets at banks with 500mm plus, including assets at holding company), Federal Reserve for all others

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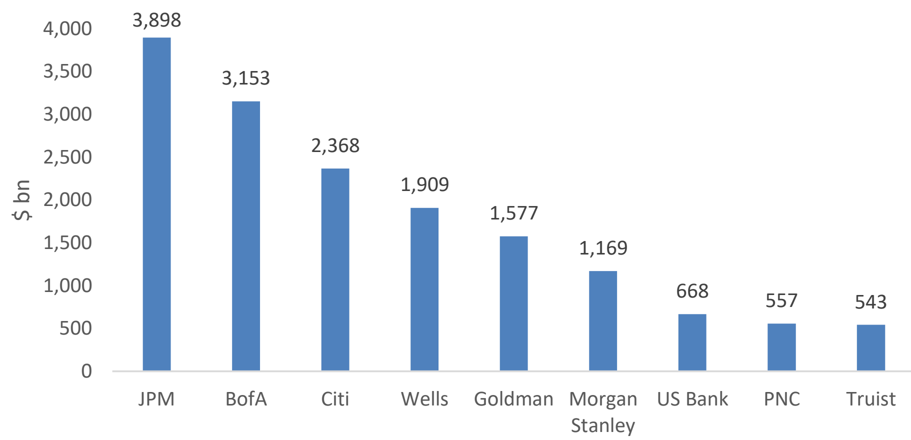
The top tier banks stand to be the largest and earliest adopters of reg cap, particularly given the disproportionate impact of the Basel Endgame Proposal on these institutions.

Figure 15: Largest US Banks by Assets

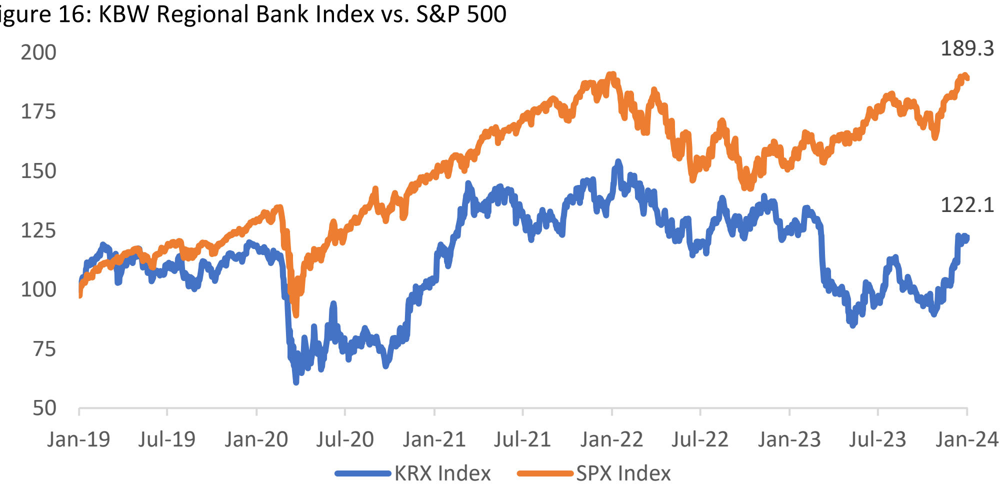


Source: Bloomberg

US regional banks face capital needs and business challenges, and will follow large banks as reg cap issuers

Issuance will penetrate down to the regional bank level, though it will take more time. Merchants Bank (see Figure 6) is a noteworthy issuer of reg cap transactions from the $10-50 billion asset size category. Regional banks face particular pressure from deposit outflows, and many are exposed to long-term fixed-rate assets as well as commercial real estate. Regional bank share prices have significantly underperformed the S&P over the past 5 years, and declined slightly in 2023, as a year-end rally was not sufficient to overcome the dramatic drop following SVB late in the first quarter. This underscores the challenges faced by regional banks, as well as their acute need for an alternative source of capital.

Figure 16: KBW Regional Bank Index vs. S&P 500



Source: Bloomberg. 1/2/19 level indexed to 100

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Adoption of reg cap at the regional bank level may be less as i) some may be reluctant to bear the costs in terms of fees and spread of a reg cap deal, and ii) some may struggle to muster and coordinate the internal resources required to issue and administer a deal.

Pent-up US reg cap supply could amount to between $20 and $80 billion, compared to the current market which sees €15 billion of issuance per annum

Below we produce a range of estimates for total pent-up supply in the US reg cap market. We assume banks above $10 billion or $100 billion issue reg cap referencing between 1.2% and 3.5% of their total asset portfolios. Note this is pent-up supply, and therefore dwarfs the current market, where issuance is running at ~ €15 billion per annum.

Figure 17: Estimated Pent-Up Reg Cap Supply From US Banks

Bank Size ($bn)	Number of Banks	Total Assets ($bn)	% of Assets Referenced	Assets Referenced ($bn)	% of Risk Placed	Risk Placed ($bn)
$100+	28	$20,258	1.2%	$243	10%	$24.3
$10+	132	$23,272	3.5%	$815	10%	$81.5

Source: Bloomberg, Seer Capital Research

Conclusion

Reg cap is a niche area of private credit where investors can work with banks to achieve mutual benefit. Banks in Europe, Canada, and beyond rely heavily on the product, and regulatory changes will trigger widespread adoption by US banks, although it will take time for the US market to mature fully.

At Seer we have deployed more than $1.2 billion in reg cap transactions across funds and co-investment arrangements since 2010.

Total amount invested	$1.2 billion
Number of investments	67
Number of transactions	60
Number of issuing banks	22
Date of first investment	2010

We look forward to ample supply of attractive reg cap opportunities from US banks as the market develops. In the meantime, we will leverage the following advantages to continue to grow our portfolio of attractive reg cap investments globally: i) nimble size and opportunistic approach, ii) decades of experience reviewing and negotiating complex documents and structures, iii) ability to analyze and project performance on a wide range of assets currently on bank balance sheets, iv) understanding of the regulatory environment and issues facing banks, v) awareness of the history and evolution of the reg cap market, including transactions that have underperformed and ways to avoid them, and vi) deep and longstanding relationships with specialized reg cap issuance teams at many banks globally.