The way back

Reg cap gives US banks chance to regain market share from private credit

Greater use of synthetic securitization will allow US banks to compete more effectively with the burgeoning private credit market, according to a detailed research piece from Seer Capital Management, the experienced SRT investor based in New York.

Private credit, as the paper notes, has “grown explosively” in recent years as traditional wholesale bank lending has retreated for a host of reasons.

The private credit market was worth around US$1.6trn at the end of last year, comprised by unused capital and value of current portfolios, compared to US$1trn at the end of 2020 and around US$600bn in 2017.

Punitive capital treatment of banks is the number one reason why the loan market has ceased to be as attractive to mainstream lenders. The draconian interpretation of Basel III may lead to a 16% increase in capital requirements for the largest banks, which has drawn howls of disapproval from across the industry.

The surge in private credit has also been accelerated by the dramatic rise in interest rates, which demolished the value of long-term assets at a time when banks were forced to pay depositors more. This led to the well-publicized collapse of Silicon Valley Bank (SVB) and the near-death experiences of Credit Suisse and First Republic. There have been no subsequent failures, but the problems faced by these banks are far from unique.

Banks are also exposed to commercial real estate assets, which have lost value as rates have climbed. Office space is hard hit as working from home has changed the face of the American workplace.

Yet the enhanced popularity of the SRT market in the US offers banks a way back into the lending market. “SRT will help US banks manage their capital more cost effectively, so they will be able to price loans more competitively and win more business,” says Terry Lanson, a market veteran and portfolio manager at Seer.

Synthetic securitization has teetered on the edge of being a big deal in the US for the last couple of years, but now seems at tipping point. Banks sorely need to reduce their capital requirements and regulators have, at last, indicated that they are disposed to take a more lenient view of the mechanism than in the past.

There were few deals in 2021 and 2022, but in the last couple of months JP Morgan brought perhaps US$20bn-US$25bn to the market, while other banks have had CLNs accepted by the Federal Reserve for reg cap purposes. Citi, the most established US issuer of all, has been back in the market recently as well.

There are 132 US banks with assets over US$10bn holding a cumulative US$23trn in assets. Each of these are possible candidates for reg cap deals, so the potential for the market is clearly substantial.

The paper from Seer assumes these 132 banks might do deals referencing 3.5% of their portfolio, or US$815bn. If 10% of this is placed with investors, annual issuance might be around US$81.5bn.

Even if we look only at the top 28 banks with assets over US$100bn (those now captured by the Fed's new rules) and assume 1.2% of total assets are referenced (US$243bn) then 10% of risk placed would indicate US$24.3bn of annual issuance.

Current annual issuance is around US$15bn, so even by the most conservative of assumptions, the market is set to increase drastically.

The extra breathing room created by the mechanism could allow borrowers to resume relationships with traditional banking partners.

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