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Why Regulatory Capital Relief Junior Tranches Offer the Best Risk-adjusted Returns in Fixed Income
June 2024

We believe that bank regulatory capital relief transactions are the most compelling opportunities in fixed income markets today – for both the investor and the issuer.

Overview

The bank regulatory capital relief ("Reg Cap"[1]) market is growing rapidly on the strength of a compelling relative value story. In Reg Cap transactions, investors are paid to assume a tranche of the credit risk on a specific portfolio of the issuing bank's assets, which reduces the bank's regulatory capital requirements and can dramatically improve their return on capital.[2] In essence the bank is buying "insurance" from investors. Because banks receive ancillary benefits, including capital relief, from this insurance, and because Reg Cap structures are complex and appeal to a limited investor base, the "premium" banks pay Reg Cap investors is significantly higher than dictated by the credit risk being insured.

The market grew to €18 billion of risk placed in 2023, after a total of €64 billion over the previous 7 years[3]. Now with i) rising bank capital requirements globally, and ii) regulatory clarity bringing the US market online, we estimate annual issuance could easily grow to $25-30bn in the next year or two. The 2023 banking crisis highlighted the need for more stringent capital requirements and placed stress on markets for alternative sources of capital for banks, which should spur Reg Cap issuance activity. At the same time, this environment has led to both wider pricing on Reg Cap transactions, and better credit quality, a double boon for investors. Credit risk has improved in several ways, including higher quality assets referenced, thicker tranches (reducing structural leverage and hence credit risk) and tighter criteria for referenced assets.

The Reg Cap asset class offers investors some unique benefits, such as:

- It is an inherently defensive credit product with typical breakeven yields at over 4x expected losses.
- It exploits complex asset-by-asset differences between regulatory capital requirements and actual risk, to the benefit of both investors and the issuers (large, global banks).
- It enjoys significant barriers to entry which also creates a yield advantage.
- Its MTM (mark-to-market) risk has proven relatively muted through several market cycles.
- It offers indicative yields of 14-16% (without leverage), on a floating rate basis.

In sum, we believe that these factors make Reg Cap transactions one of the most attractive opportunities in fixed income markets today. We discuss these factors in detail below.

[1] *This sector is also sometimes referred to as "Significant Risk Transfer" or "SRT"; we will use the term "Reg Cap".*
[2] *For a discussion of the mechanics of Reg Cap transactions, and benefits of Reg Cap from the issuer perspective, please see the Appendix on pages 10 and 11.*
[3] *Source: IACPM*

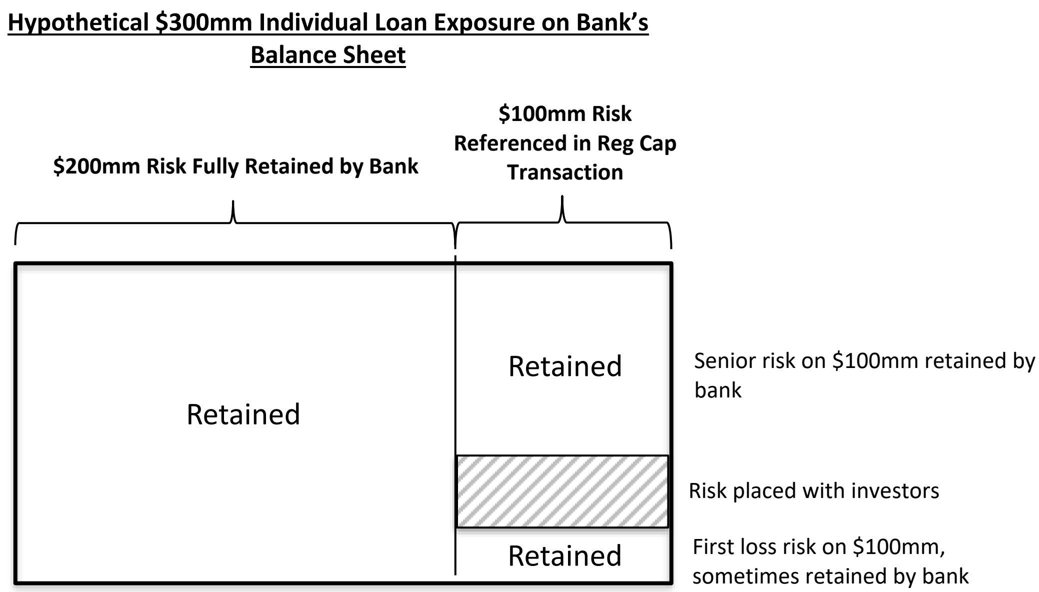
The reference assets in Reg Cap offer superior credit performance, with the banks interests very closely aligned with investors'.

Reg Cap – an inherently defensive credit product

A key distinguishing characteristic of Reg Cap is robust credit, largely driven by the strong alignment of interests between the issuing bank and investors. Reg Cap assets represent a cross section of the bank's core lending to its own clients, originated and approved with the intent to hold on the bank's balance sheet. Reg Cap issuers also retain a significant amount of the risk, often including the first loss. In addition, banks are incentivized to ensure that their Reg Cap deals perform well, in order to preserve access to the market, an important tool in their management of capital.

Exhibit 1 illustrates the unusually strong alignment of interests between banks and investors that springs from the design of Reg Cap transactions. Assume, for example, a bank lends $300mm to a large corporation. The bank might seek regulatory capital relief on only a portion of the loan: 1/3rd or $100 million in our example. The block on the left in Exhibit 1 is the $200mm. The block on the right illustrates what would occur if the bank chose to reference $100mm of their exposure in a Regulatory Capital Relief transaction. Reg Cap investors would be assuming *some* of the credit risk (shaded) on $100mm of the loan. In this example, the Reg Cap issuer continues to be exposed to all of the risk on $200mm of the loan. On the $100mm portion, the Reg Cap issuer is exposed to the first losses on the loan (up to a an "attachment" percentage), and the investor is exposed to the losses above that, up to the "detachment" percentage. It is clear from the illustration that the Reg Cap issuer is still very much exposed to this loan, and will originate, service and (if need be) work out this loan with the same care as any other credit exposure.

Exhibit 1: Banks generally retain a significant share of referenced assets in Reg Cap



This strong alignment of interests contrasts with ABS and MBS, where the "originate to distribute" business models of many specialty finance and marketplace lenders are focused primarily on maximizing loan volumes --- and retaining only the minimum required risk. It also contrasts with CLOs, where the manager is motivated to generate fees and maximize equity returns by "levering up" the underlying credits. Lastly, in synthetic credit trades, the investor assumes risk on credits that

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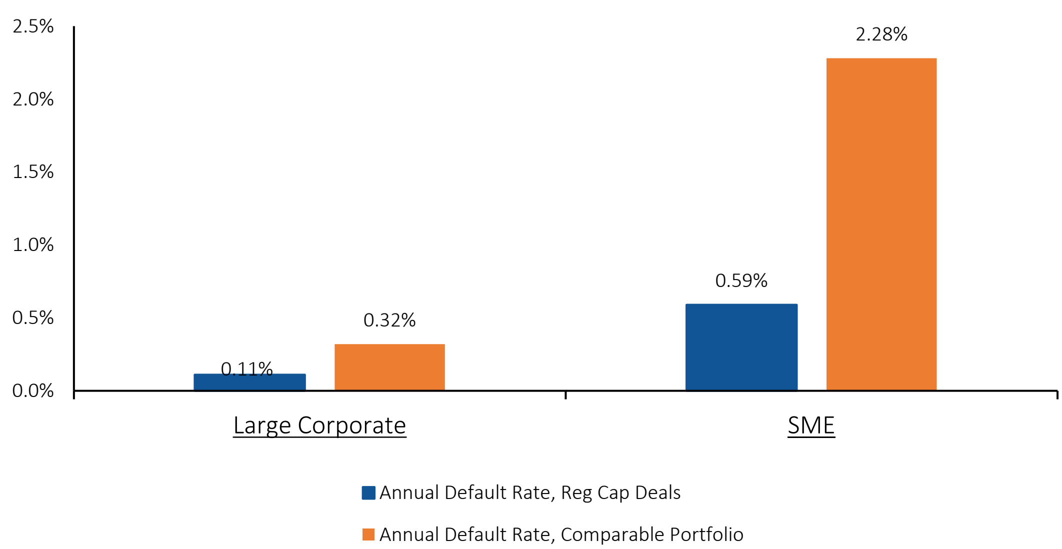
were selected because they are deemed attractive shorting opportunities by a counterparty. All of these are qualitatively different than the core lending book of a bank, whose underwriting processes are also reviewed by banking regulators tasked with assessing safety and soundness. History has shown that assets originated as part of a bank's core operations are likely to be higher credit quality, all else equal. Moreover, those assets selected as reference assets by Reg Cap issuers are even higher credit quality that the overall core lending book. As mentioned above, banks select assets for Reg Cap deals carefully, in an effort to ensure strong performance and maintain continued access to the market. Also, the investors in Reg Cap deals exercise a further layer of discretion, often insisting on removal of specific credits, tightening of replenishment criteria, and concentration limits. Experienced investors add significant value by applying their knowledge and experience in negotiating such terms to further strengthen the credit profile of a Reg Cap transaction.

A study cited by the European Banking Authority (EBA) concluded that assets in Reg Cap deals performed significantly better than other similar assets on banks' balance sheets, as shown in Exhibit 2. The EBA notes in their study that "Both default and loss rates …are significantly lower than those for comparable portfolios... This indicates that the originators tend to systematically choose 'core' exposures for the synthetic securitisation, with better default and loss performance than for comparable exposures held on the balance sheet."

Exhibit 2: Outperformance of Assets in Reg Cap Transactions vs. Comparable Exposures[4]

Historically, the referenced assets in Reg Cap deals have lower defaults and losses than other similar assets wholly retained by the issuing bank.



Another attractive element of the credit risk profile of Reg Cap is the sheer variety of credit assets that are referenced in various Reg Cap transactions. Many of these assets are highly granular, and

[4] *Source: September 2019 Discussion Paper on Synthetic Securitisation by the European Banking Authority (EBA). Comparable portfolio constitutes a comparable but broader portfolio of the bank. Based on a study of 70 transactions executed by 14 banks covering the period 2008-2019, including 26 large corporate transactions and 21 SME transactions.*

many of them are not generally otherwise available for investment by fixed income investors (see Exhibit 3 below).

The reference assets in Reg Cap also provide diversification opportunities.

Exhibit 3: Reg Cap investors can gain exposure to a wide range of attractive credit assets:

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

In the current environment, some investors may find that Reg Cap provides an attractive diversification play away from sectors that have been hard hit by rising rates, such as commercial real estate, where property values have fallen, or residential mortgages, where slowing prepayments have created extension risk, or leveraged loans, where earnings have not kept up with rising rates, coverage ratios have fallen, and recovery rates, in particular, have started to come in significantly below expectations and historical levels. Reg Cap offers both an opportunity to reallocate exposure to reference assets that are outside of these sectors, and the ability for an investor to "move up the credit spectrum" in these sectors by reallocating their exposure to Reg Cap.

Bank capital requirements create anomalies that investors can profitably exploit.

<u>Reg Cap exploits complex asset-by-asset differences between regulatory capital requirements and actual risk</u>

Bank capital requirements can be quite complex. They vary not only by asset type but by jurisdiction and have been evolving over time. It is often the case, however, that, at the asset level, regulatory capital requirements for a given asset are less nuanced than capital market risk assessments for that same asset. This is becoming increasingly the case as Basel IV banking reforms require that risk-weighted assets be calculated based on a standardized formula, in an effort to reduce reliance on banks' internal risk models. The result of this paradigm is that referenced assets are often higher quality and lower risk than the pool of assets from which they are selected. If regulators lump a group of assets together and require the same amount of capital against all of them, a Reg Cap issuer will parse that group into finer risk strata. When they issue a deal, they use the highest quality assets as reference assets, because that will help them achieve the best deal execution at the lowest cost. Thus, it typically behooves a Reg Cap issuer to choose the least risky reference assets among those with the same capital treatment, creating an upward bias in the credit quality of referenced assets. An illustrative example of this follows.

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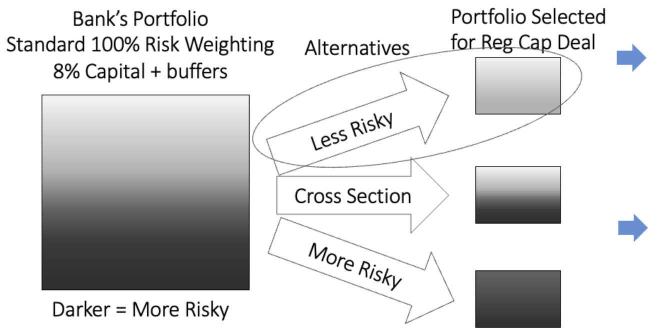
Exhibit 4: Illustrative Example of Regulatory Capital Regime vs. Asset Risk



The bank will obtain the same amount of capital relief regardless of the assets it includes, so it will select less risky assets to minimize the cost of protection

The reg cap investor exploits the disconnect between the high capital charge and the low risk of the assets selected

Barriers to entry for investors keep yields high relative to the risk.

Reg Cap – barriers to entry create attractive opportunities for a select few

While many asset allocators may recognize the attractive risk/return profile of Reg Cap, often they are faced with significant barriers to entry. First, most transactions are distributed via a limited process that is outside normal syndication channels. Investors need to establish regular dialogue and a history with issuer contacts in order to source attractive deals. Prospective purchasers of Reg Cap transactions are required to sign Non-Disclosure Agreements in order to review offering materials and perform due diligence. This further limits distribution. Perhaps most importantly, Reg Cap investors need specialized knowledge, as detailed in Exhibit 5 below. As is generally the case, these barriers to entry create an environment where above-market risk-adjusted returns are possible.

Exhibit 5: Specialized Knowledge Creates Barriers to Entry

Area of Expertise Required	Description
Structural Complexity	• Reg Cap transactions are synthetic securitizations and are therefore neither a simple corporate obligation nor a pure securitization, but a hybrid of both. Not all investors may have an investment "bucket" for this hybrid.
Understanding of Banks	• Understand bank origination, underwriting, and loss mitigation practices. • Understand bank motivations – capital, balance sheet, and risk management. • Assess alignment of interests.
Asset Analytics	• Project loss performance on a range of different bank lending products from corporate to consumer, including secured and unsecured.
Deal Documents	• Understand key points of bespoke credit default swap documents. • Balance investor protections vs. regulatory and business constraints faced by banks. • Establish tight criteria for replenishment to protect against portfolio migration.

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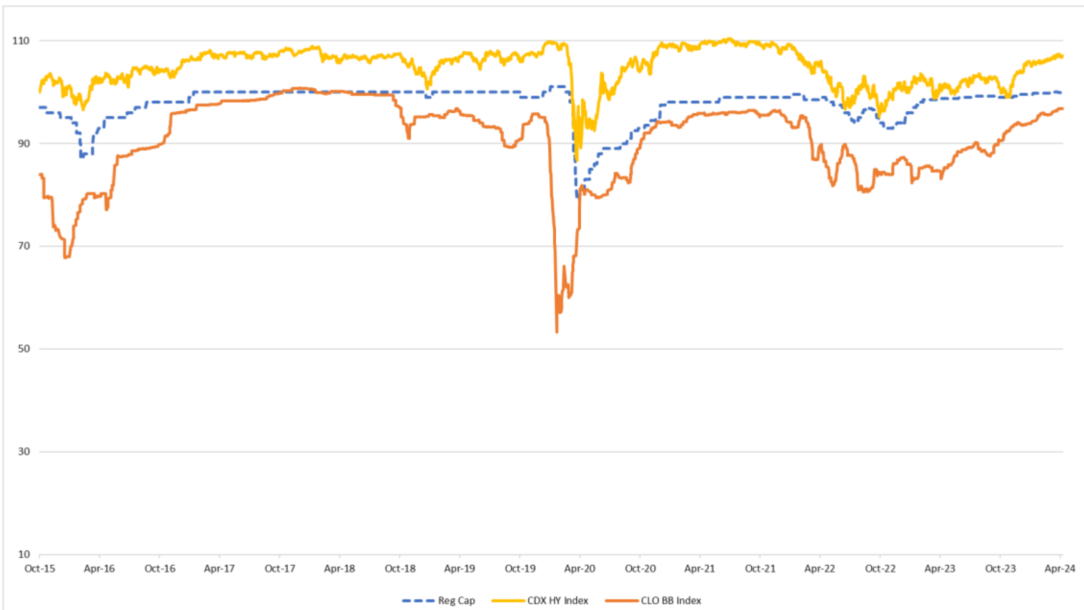
Through several cycles, Reg Cap price volatility has been muted, particularly relative to comparable credit risk.

<u>Reg Cap – muted Mark-to-Market risk makes Reg Cap particularly attractive</u>

Generally, higher-yielding investments exhibit greater price volatility. Despite this, Reg Cap has proven relatively less volatile, even during crises. We believe this is due to the small, almost club-like investor base, which tends to use modest leverage and often invests "locked up" capital, obviating the need to sell assets in down markets. As a result, the Reg Cap market has relatively tighter bid/ask spreads, even under stress, and has seen shallower selloffs than competing products such as BB CLOs, for example (see Exhibit 6 below).

Exhibit 6: Relative volatility of CLO BB vs. Reg Cap vs. High Yield Index Prices [5]



Recent events suggest that we will see both a greater volume of Reg Cap issuance and even more attractive terms.

<u>Reg Cap – today's environment is particularly opportune for Reg Cap investing</u>

Last year's events in the banking sector (Silicon Valley Bank, Credit Suisse et al) have led to heightened scrutiny of bank capital requirements. It is expected that regulators will increase capital requirements not just for some smaller banks, where regulations have been more lax, but for larger banks as well. The international overhaul of capital requirements that began in the aftermath of the Great Recession and is now gaining even more traction. In late July, 2023, US banking regulators proposed a complete overhaul of capital regulations that would increase capital requirements, especially on the largest banks and banks between $100bn and $250bn in assets. While the Fed has recently announced that the proposed overhaul is likely to be changed significantly before implementation, overall capital requirements are set to increase. There are 28 US banks with over $100bn in assets; as a group they represent $20.3 trillion in assets. These banks will not only need more capital, and many will also find it more expensive to obtain capital, as regional bank share prices haven't fully recovered from last year's selloff.

[5] *HY is price of generic 5-year high yield CDX index. Source Bloomberg, Seer Capital Research*

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Reg Cap transactions currently offer returns in the mid-teens.

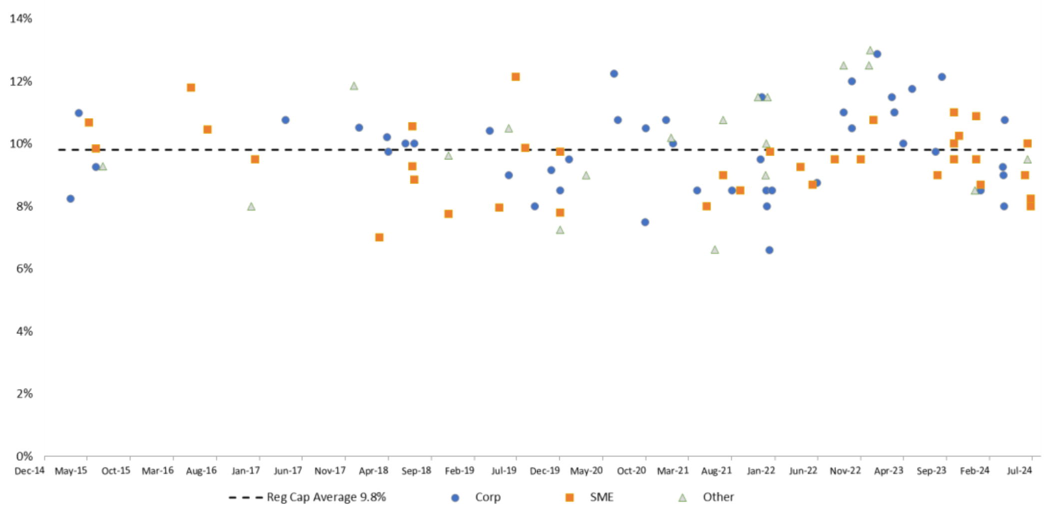
Perhaps less intuitively, recently issued Reg Cap deals have been placed on more attractive terms, vis-à-vis the structure, the reference assets, the pricing, or all three. Historically, issuers have tended to react to spread-widening events by offering even more attractive assets and structural features, in order to maintain a consistently low cost of capital relief.

Reg Cap offers generous returns

Reg Cap yields vary based on the assets referenced, the deal structure, and the issuer. As a spread over SOFR, the sector generally offers spreads in the 8-12% range. Seer has invested over $1.2 bn in Reg Cap since 2010, with average return across positions of 13.1%[6]. While Reg Cap is attractive and competitive on an unlevered basis, repo leverage is available against individual Reg Cap transactions. Advance rates are in the 50% range at spreads of ~200bp over SOFR, creating levered yields in the high teens to low 20s. Leverage at the portfolio level can be even more attractive, with limited margin risk.

A spread history for the market is shown below.

Exhibit 7: Reg Cap Spread History



Source: Seer Capital Research. Reflects selected first and second loss tranches but excludes mezzanine and thick (i.e. 0-12.5%) tranches.

6 *Simple average return on Seer Reg Cap investments. Assumes all positions held to date; investor returns have differed in light of trading activity. More information about these returns is available upon request.*

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Reg Cap is compelling on a relative value basis

Reg Cap offers superior risk-adjusted returns.

Although admittedly less liquid, Reg Cap offers yields that are multiples of more traditional fixed income investments, such as investment grade and high yield bonds, and agency MBS (which of course entails prepayment risk rather than credit risk). Exhibit 8 below shows a relative value comparison.

Exhibit 8: Reg Cap vs. Relative Value Summary:

Item	Reg Cap	CLO BB	CLO equity	CMBS B-Piece	RMBS residuals	High Yield Corporate	High Grade Corporate	Agency MBS
Market Size($bn)	$40-50	$50	$30-50	$25-$30	$1-1.5	$1,353	$8,523	$8.740
Indicative Yield	13-15%	12-13%	14-16%	20-21%	12-14%	7.5%	4.8%	5.8%
Stressed Yield (i.e. 2x base case losses)	7%	12-13%	<0%	<0%	4-5%	N/A	N/A	N/A
Duration	5 yr.	5.7 yr.	3.5 yr.	4.5 yr.	5.5 yr.	~5yr	~5yr	~6yr
Underlying Assets	IG Corporates, SME, Consumer Assets, others	Sub IG Leveraged Loans	Sub IG Leveraged Loans	Commercial Mortgages	Residential Mortgages	High Yield	Corporates	Residential Mortgages
Asset Credit Risk	Low/Medium	Higher	Higher	Medium	Low	High	Medium	Nil
Credit Protection	Low/Medium	Strong	N/A	Low/ Medium	N/A	N/A	N/A	Guaranteed
Attach-Detach% [7]	Varies, typically 0 or 1-8%	8-13 %	0-8%	0-7%	0%-100%	N/A	N/A	N/A
Pandemic Selloff	22%	44%	~50%	30%	N/A[8]	21%	5%	N/A[9]
Loss Expectation	Low (lower risk assets, strong goal alignment)	Low; 8% equity absorbs first ≈25% of defaults	High	2-3% of collateral pool	Minimal	Medium	Low	Nil
Number of Names (Obligors)	50-1000+	250-300	250-300	25-60	750+	N/A	N/A	N/A
Names Disclosed	Sometimes	Yes	Yes	Yes	No	Yes	Yes	N/A

Within structured credit, nominal yields on Reg Cap transactions are fairly comparable to other higher yielding sub-sectors. However, given their lower credit risk, Reg Cap strongly outperforms most of those subsectors in stress scenarios. The only sector with stronger projected performance in a stress scenario is CLO BBs, however they are a riskier investment both fundamentally and technically. Exhibit 9 below lays out some of the differences between these two investments.

[7] *Attach and detach points in Reg Cap vary by referenced asset. For example, 1-10% would be typical for Middle Market and Leveraged Loans, 1-8% for SME lending, 0-4% for Large Corporates, and 0-7% for Capital Call Facilities.*
[8] *Insufficient trading activity for price discovery.*
[9] *Due to flight to quality, Agency MBS rallied during the pandemic, and were up ~4% generically.*

Exhibit 9: Reg Cap and BB CLO comparisons

	Reg Cap	BB CLO
Assets	Wide range of lending products originated by banks to their core clients for their balance sheets, many of them investment grade / equivalent rated	Loans originated to finance leveraged takeovers of companies by private equity firms, generally BB or B rated
Originator / Manager Motivation	Banks originate assets for their balance sheet, then select them for reg cap deals to obtain capital relief	CLO managers purchase leveraged loans to generate management fees and maximize returns on the equity tranche
Credit Enhancement	Banks often retain small first-loss position equal to expected losses on the portfolio, thought they occasionally sell the first-loss	Subordination in the form of equity plus excess spread
Duration	Generally, 3-5 years	Generally, 5-7 years
Market Volatility	Buy-and-hold investor base with locked-up capital using limited leverage makes for dampened volatility during market selloffs	Highly levered, trading-oriented investors make for extreme market beta

Conclusion

Reg Cap transactions offer knowledgeable and experienced investors the opportunity to generate stable, high yields from a diversified portfolio of credit assets. Those assets are positively selected by the issuing bank, as demonstrated by a track record of very strong credit performance.

Seer's team has extensive Reg Cap experience, including involvement in creating the sector at predecessor institutions that remain active in issuing Reg Cap, and 71 investments at Seer totaling nearly $1.3 billion since 2010 (a third of that over the last two years). With above-market yields, relatively low volatility, and minimal credit risk, we believe that Reg Cap represents one of the most attractive risk-adjusted credit plays in fixed income markets today.

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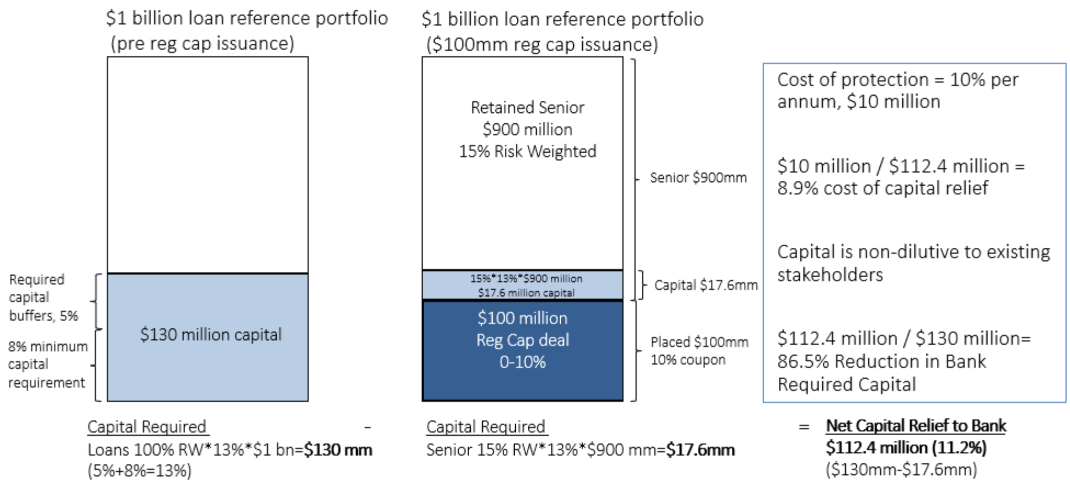
Appendix: Reg Cap from the Issuing Bank's Perspective

Exhibit A. Illustrative Bank Regulatory Capital Relief Example

Capital relief to the issuing bank depends on the capital treatment of the assets referenced in the Reg Cap transaction, amount of risk placed, and capital treatment of the senior interest retained by the bank post issuance.



Assumes 15% risk weighting for retained senior classes of Reg Cap is based on Basel III framework.
Simplified example for illustrative purposes only.

Exhibit B. Illustration of How Regulatory Capital Relief Improves the Bank's Return on Capital

		Before Reg Cap Issuance ($mm)	After Reg Cap Issuance ($mm)
Reference Portfolio		1000.0	1000.0
Coupon Yield on Portfolio	6.5%	65.0	65.0
Capital Required [1]	13.0%	130.0	17.6
Bank Cost of Debt	5.0%	43.5	49.1
Cost of Reg Cap Deal [2]	10.0%	0.0	10.0
Net Interest Margin (Coupon yield less Bank Cost of Debt and less Cost of Reg Cap Deal if applicable)		21.5	5.9
Return on Capital (NIM/Capital Required)		**17%**	**34%**

[1] *Assumes assets are 100% risk-weighted, with 8% capital + 5% buffers required (13% total). Assumes the balance of the portfolio is financed with debt at 5.0%; ($1000-130) x .05=$43.5.*
[2] *Assumes a 0-10% tranche of Reg Cap deal placed at a spread of 10%. Following issuance, the 90% retained senior is assumed to be 15% risk-weighted for this example. Therefore, the capital requirement post-issuance is $900 x .15 x .13, or $17.6. The balance of the portfolio is financed with debt at 5.0%; ($1000-17.6) x .05=$49.1*

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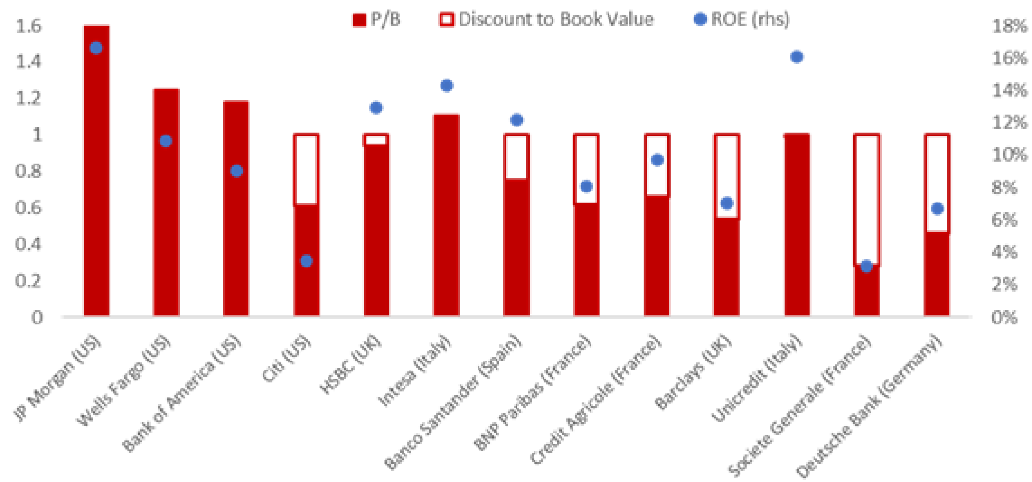
Exhibit C. With Many Global Banks' Equity Trading at a Discount to Book, Reg Cap is a Superior Alternative for Meeting Rising Capital Requirements



Source: Bloomberg as of 6/12/2024

Exhibit D.
Multiple Benefits for Banks
Banks can achieve multiple benefits from Reg Cap transactions, which Seer expects will continue to drive significant supply growth:

Benefit	Description
Manage Capital	• Meet new higher Basel capital standards • Create value by raising capital to buy back shares at a discount • Release capital from low ROE businesses • Raise capital against asset portfolios with high regulatory capital requirements relative to the underlying credit risk
Manage Risk	• Reduce 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