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Coming Opportunities in US Reg Cap

July 2024

This is the fourth article in a series devoted to explaining the bank regulatory capital space ("Reg Cap", sometimes referred to as "significant risk transfer" or "SRT").

Article 1 – https://seercap.com/wp-content/uploads/2024/07/Reg-Cap-A-Better-Way-for-Private-Credit-to-Partner-With-Banks.pdf
Article 2 – https://seercap.com/wp-content/uploads/2024/07/Reg-Cap-Market-Poised-for-Continued-Growth-web.pdf
Article 3 – https://seercap.com/wp-content/uploads/2024/07/Regulatory-Clarification-Opens-US-Reg-Cap-Market-web.pdf

US vs European Reg Cap Market

The US regulatory clarification in September 2023 has helped make Reg Cap one of the hottest trades in the market, with new investors and allocators eager to participate and almost daily coverage in the mainstream financial press. The initial wave of US Reg Cap deals has primarily consisted of thick tranches referencing investment grade corporate assets placed with large investors at spreads in the mid-single digits, and thin tranches referencing auto loans placed at rapidly tightening spreads.

Tight pricing on US Reg Cap deals is driven partly by the influx of capital into US private credit. As discussed in Article 1 of this series, many large buy-side firms have raised substantial sums for private credit that they are struggling to deploy. Some view reg cap as within their private credit mandate and have bid aggressively for large bilateral Reg Cap trades with the likes of JP Morgan and Citi in an effort to deploy capital quickly. While this arrangement can benefit both fund managers and banks in the short term, the end investors in these funds may not be receiving returns that adequately compensate for the risks.

Seer has not found the initial wave of US Reg Cap deals attractive relative to European Reg Cap.

Seer has not found the initial wave of US deals attractive relative to European Reg Cap issuance. On the back of the hype around the US market, we have seen greater demand for some European transactions in recent months, but spreads overall have remained in line with the past several years. European issuers who have established issuance programs over the past 10+ years continue to transact with a limited number of longstanding partners, rather than with new players who express eagerness to join the market but are unlikely to be long-term participants. Regulators, concerned about "flowback risk" of assets returning to bank's balance sheets if maturing Reg Cap deals cannot be replaced, also encourage issuers to maintain stable distribution partners.

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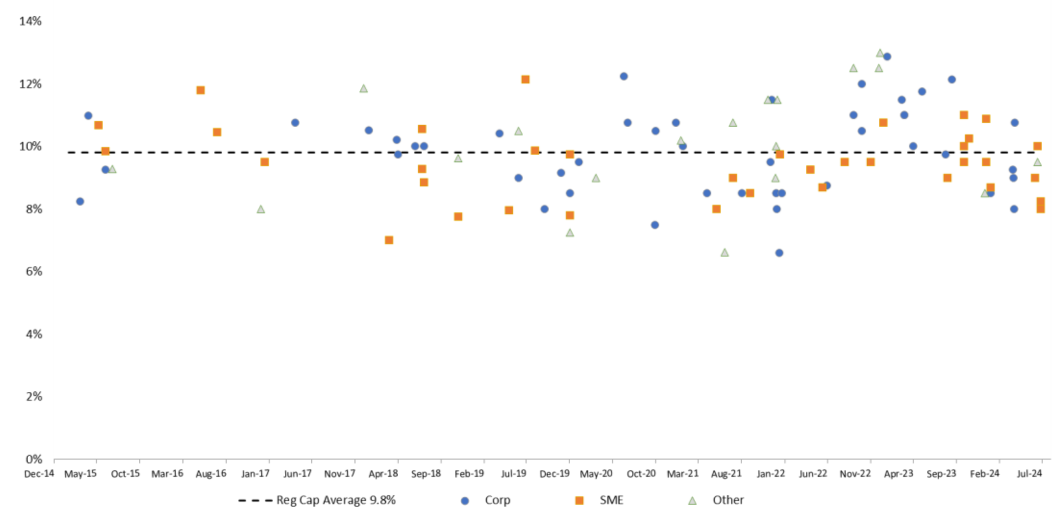
Figure 1: New Issue Reg Cap Spreads



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

Growth Prospects for the US Reg Cap Market

We believe that in time, many US banks of all sizes will take advantage of Reg Cap. As the market develops and supply increases, spreads in US Reg Cap should widen back to appropriate levels.

We see significant motivations for Reg Cap issuance by US banks of all sizes.

Figure 2: Breakdown of US Banks by Total Assets

Size ($ bn)	Number of Banks	Total Assets ($ bn)	Considerations
1,000+	6	14,075	Even with final Basel reforms likely less onerous than feared, these banks will be under pressure to optimize capital deployment across portfolios and businesses, in line with global competitors
500-100	3	1,768	
200-500	10	2,970	Regional banks will face capital pressure due to losses on "available for sale" securities, adding to existing problems from CRE office exposure, deposit outflows, and low share prices
100-200	9	1,445	
50-100	12	887	Smaller regional banks have capital needs but may struggle to marshal the internal resources needed to complete a complex reg cap deal
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

As veterans of the European market are quick to note, the European reg cap market has taken years to reach its current robust state, and the US market will similarly take time to fully develop. In the

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meantime, we expect many of the new investors exploring the US market to become frustrated and return to their previous focus areas.

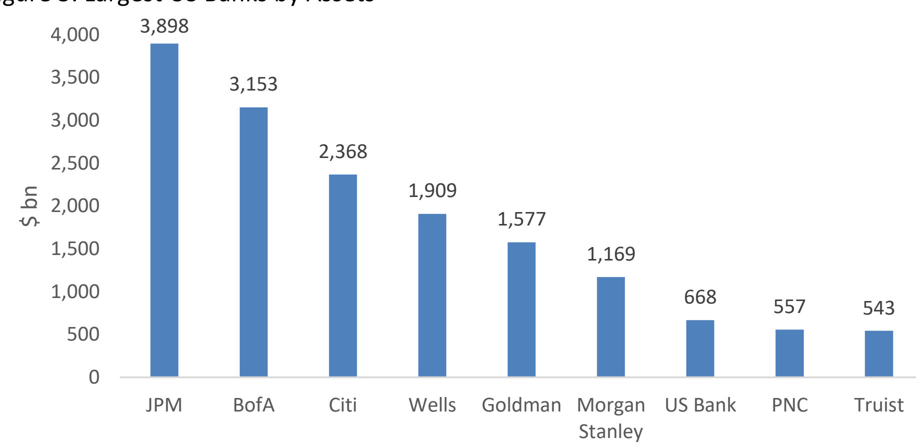
Key factors that will contribute to the growth of the US market in size and diversity in the near to medium term include:

- Clarification of regulatory environment
- Establishment of consensus around optimal structure, likely SPV structure that can be used for all types of assets and syndicated to a variety of investors
- Large banks that have completed an initial wave of deals backed by on-the-run assets such as IG corporate loans will look to other areas of their balance sheet to optimize capital allocation
- Smaller banks will devote the time and marshal the resources needed to complete a first-time transaction
- As more and more banks join the market, Reg Cap will become a standard tool which investors / equity analysts expect US banks to employ, as they do in Europe

Large US Banks

We have already seen issuance by JP Morgan, Citi, Morgan Stanley, and US Bank since September 2023, and we expect most if not all the other large US banks listed in the table below to follow in time. These banks have started with large deals backed by investment grade corporate exposures and capital call facilities to clear pent-up supply at the tightest pricing, but we expect them to subsequently turn to broadly syndicated deals backed by a wider range of collateral.

Figure 3: Largest US Banks by Assets



Source: Bloomberg

US Regional Banks

Regional bank shares have significantly underperformed the S&P 500 in recent years. This underscores the challenges faced by these banks, as well as their acute need for an alternative source of capital.

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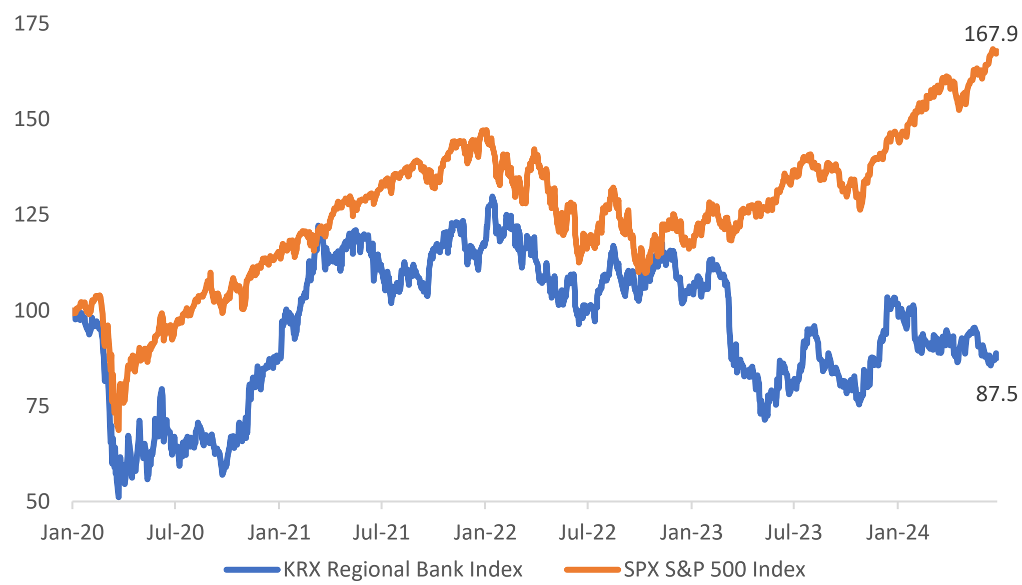
Figure 3: KBW Regional Bank Index vs. S&P 500



Source: Bloomberg as at 6/25/2024. 1/2/20 level indexed to 100

Reg Cap is not the appropriate vehicle for regional banks to dispose of distressed commercial real estate assets. However, many regional banks have unique lending products which they can reference to raise capital efficiently.

Regional banks face well publicized problems with high commercial real estate exposures. Commercial real estate values have fallen broadly due to higher interest rates, with office properties particularly hard hit by changing demand as well. At Seer we do not view reg cap as the appropriate vehicle for banks to dispose of distressed assets, and we would not be investing in reg cap deals referencing stressed commercial real estate assets from regional banks.

On the other hand, many regional banks have unique customer or product niches in specific regions, and they are likely to reference high quality loans to these customers in reg cap deals as an efficient way of raising capital. These transactions will likely represent attractive opportunities. Adoption of reg cap at the regional bank level will take more time as i) some may be reluctant to bear the costs in terms of fees and spreads of a reg cap deal, and ii) some may struggle to implement the processes required to issue and administer a deal. But we point to Merchants Bank of Indiana, a bank with two reg cap deals outstanding referencing nearly $3 billion of its $17 billion of total assets, as proof that the product can make sense for small regional banks.

Projecting US Issuance Totals

We project US issuance volume based on the behavior of established European and Canadian Reg Cap issuers. The chart below shows assets protected in outstanding Reg Cap deals as a percentage of total assets on balance sheet among selected Reg Cap issuers. These issuers have purchased protection on between 1.2% and 3.5% of their total assets.

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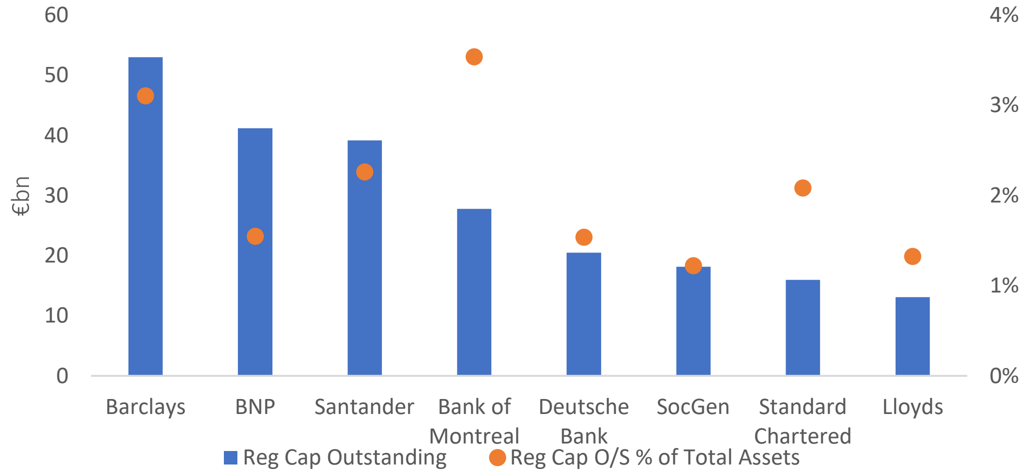
Figure 4: Reg Cap Outstanding by Leading Issuers



Source: Company Filings, as at year end 2022

Using that experience, we produce a range of estimates for total pent-up supply in the US Reg Cap market. We assume different levels of take-up, ranging from banks above $100 billion in assets referencing 1.2% of their total assets to banks above $10 billion in assets referencing 3.5% of their total assets. Note this is pent-up supply, which should be reduced by approximately $10 billion issued between September 2023 and now.

We estimate further pent-up Reg Cap supply from US banks at between $14 and $71 billion, after which the US will become a significant contributor to regular way issuance.

Figure 5: Estimated Pent-Up Reg Cap Supply From US Banks

Bank Size ($bn)	Number of Banks	Total Assets of this cohort ($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

Once this pent-up supply is cleared the US market will be a significant contributor to regular way issuance, which stands at approximately $15 billion per annum ex-US as of now.

We look forward to ample supply of attractive Reg Cap opportunities from US banks as the market develops over the coming months and years. In the meantime, investors who have long established partnerships with European and global banks will continue to find attractive opportunities, which will afford them the patience and flexibility to await the maturation of the US market.