Seer Capital Management LP
1177 Avenue of the Americas, 4th Floor
New York, NY 10036
(212) 850-9035
www.seercap.com

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Reg Cap: A Better Way for Private Credit to Partner with Banks

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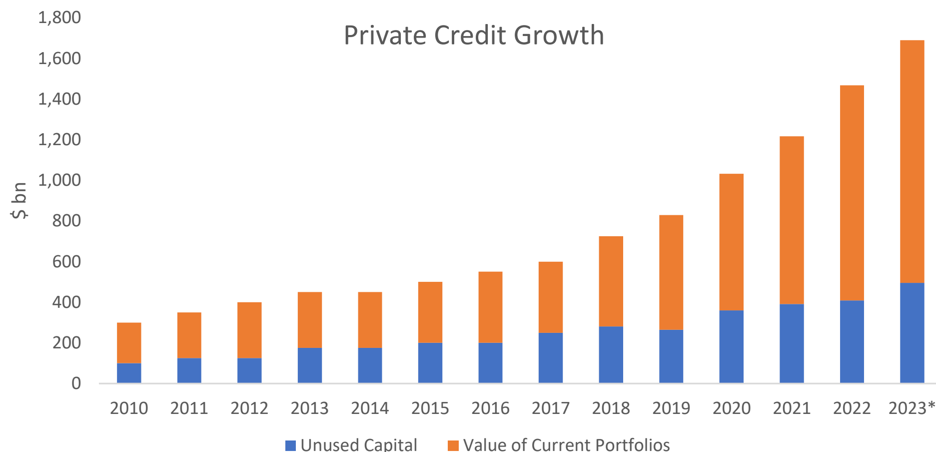
This is the first in a series of articles devoted to explaining the regulatory capital space ("reg cap", sometimes referred to as "significant risk transfer" or "SRT") and why it is currently an attractive sector within private credit.

Unprecedented Expansion in Private Credit

Private credit has grown explosively in the last few years, becoming a major focus for large asset managers, but with such growth comes potential excesses. Seer believes that reg cap is the best vehicle for private credit investors to gain exposure to prudent lending in partnership with banks.

Global private credit assets currently stand at ~$1.8 trillion, four times more than a decade ago. Some industry participants expect the market to further double to $3.5 trillion by 2028.

Figure 1: Private Credit Growth



** 2023 through June. Source: Bloomberg*

Asset managers have gathered a vast amount of capital for private credit that they are incentivized to deploy. Less experienced and disciplined managers may struggle to deploy it prudently.

Private credit, which encompasses a range of products, is touted by some as a replacement for bank balance sheet lending and a more efficient way of delivering credit to the economy. Some have termed this the "golden era of private credit."

On the other hand, some industry participants, journalists, and regulators have expressed concerns about a bubble in private credit and warned of contagion when it inevitably bursts. The truth is likely somewhere in the middle. Asset managers armed with enormous amounts of newly raised capital ($200-300 billion total in 2023) are motivated to deploy before the end of their investment period. Aggressive deployment can result in style drift and lax lending standards, especially among managers who are relatively new to the market and lack deep relationships and a disciplined approach.

Seer Capital Management has prepared this memorandum using information gathered from third parties as well as its own independent research, all of which it believes to be accurate as of the date hereof. While this memorandum represents our current thinking, future events could lead to a change in our opinion, and there can be no guarantee that the opinions expressed herein will be borne out by the market or underlying asset performance. No offering of any investment product managed by Seer Capital Management is intended hereby.

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The migration of lending away from banks began in the aftermath of the financial crisis and has accelerated due to continued challenges faced by banks, highlighted by the 2023 failures of Silicon Valley Bank and Credit Suisse. For more on the bank turmoil of early 2023 please see: https://seercap.com/wp-content/uploads/2023/04/Bank-Turmoil-Creates-Compelling-Opportunities-in-Reg-Cap.pdf

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. Ultimately, private capital and banks are both vital players in the granting of credit to the economy. Carefully structured partnerships between asset managers and banks can make for optimal credit distribution.

Asset Managers and Banks Establishing Direct Lending Partnerships

Some asset managers have established direct lending partnerships with banks where asset managers provide capital and banks source loans via their existing branch network and salesforce. These partnerships can be mutually beneficial-- banks serve their lending clients while preserving precious capital, and asset managers find outlets for the funds they have raised.

"Sourcing" is a significant competitive advantage in direct lending. Firms that combine strong sourcing capability (via large in-house marketing teams) with prudent underwriting (rejecting suboptimal credits) will outperform their benchmark over the cycle. However, many asset managers that have raised capital for direct lending lack significant in-house origination capability and need other sourcing channels.

Direct lending partnerships between banks and asset managers may suffer from an inherent conflict of interest-- loans that the bank shows to the partnership may be adversely selected.

Direct lending partnerships between banks and asset managers may suffer from an inherent conflict of interest. Especially where banks contribute limited capital, they may be inclined to originate higher-quality loans for their balance sheet while passing lower-quality loans to the partnership.

The below table lists some recently announced direct lending joint ventures between asset managers and banks.

Bank	Partner	Description
Barclays	AGL Credit Management, Abu Dhabi Investment Authority	ADIA committed $1 billion, Barclays not committing balance sheet
Bank of Montreal	Oak Hill	Deployed more than $12 billion since 2021
Citi	Luminarx	Luminarx and partners committing more than $2 billion
PNC	TCW	Platform aiming for $2.5 billion in first year
Societe Generale	Brookfield Asset Management	Plan to raise $10.8 billion fund
Wells Fargo	Centerbridge	$5 billion direct lending fund
Stifel Financial	Lord Abbett & Co.	
Webster Financial	Marathon Asset Management	

Source: Bloomberg

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“When the sh*t hits the fan—and it will one day, we don’t know when—there will be a lot of stranded borrowers.” -Jamie Dimon

Although JP Morgan is allocating capital to direct lending and has reportedly discussed acquisitions in the space, CEO Jamie Dimon has expressed reservations and questioned the notion that private credit is a better home for risky loans than banks. “Banks tend to work with the borrower and the middle-market loan in the [sic] crisis…private credit hasn’t dealt with high interest rates, hasn’t dealt with the recession, and it hasn’t dealt with high spreads… When the sh*t hits the fan—and it will one day, we don’t know when—there will be a lot of stranded borrowers.”

Bank Reg Cap: Seer Capital’s Preferred Mode of Partnering with Banks

At Seer Capital we are cautious about aggressive lending by private credit. Borrowers unable to obtain financing directly from banks or via leveraged loans / CLOs are turning to private credit lenders.

We believe reg cap transactions are a more prudent approach to private credit. Properly structured reg cap transactions constitute partnerships in which the sides are well aligned. Banks sell a small sliver of the risk on their core lending portfolios to market participants like Seer and obtain significant capital relief under the new Basel rules. Banks still own the bulk of the risk on each of the underlying credits in the portfolio.

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. Investors in reg cap transactions benefit from all the banks’ processes and safeguards.

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.

Within reg cap, Seer applies key tests to ensure a healthy partnership with the bank.

Test	Description
Bank motivation	We ensure that the bank is seeking capital relief for a core lending business, rather than offloading risk or exiting a business. We prefer repeat issuers who have shown a longstanding commitment to reg cap and rely on it as a capital management tool.
Bank lending	We ensure that the bank is a conservative lender with longstanding client relationships and a strong position in the relevant lending market.
Portfolio	We ensure that the underlying portfolio is diversified, so that our investment is not significantly hurt by one or a few idiosyncratic events.

Look out for our next piece in which we will delve into the reg cap market more fully.

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