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Reg Cap Market Poised for Continued Growth

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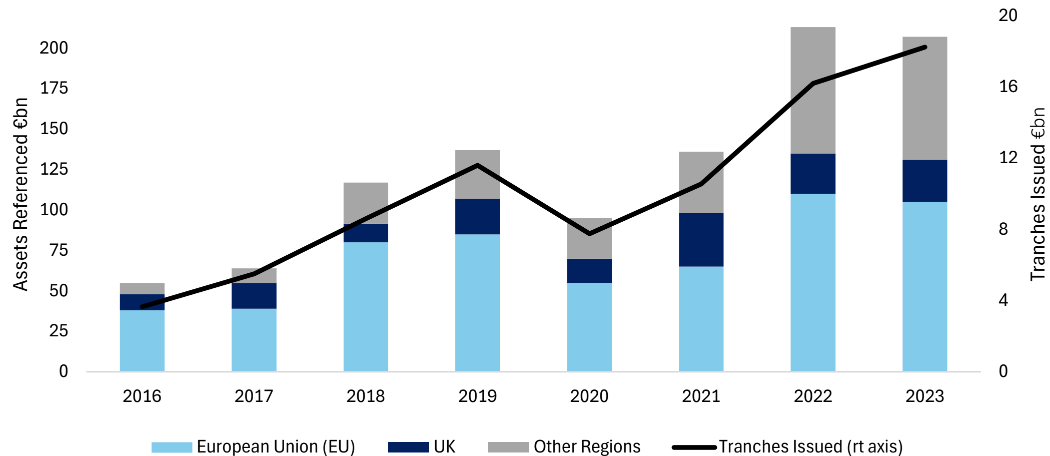
This is the second article in a series devoted to explaining the bank regulatory capital relief ("Reg Cap") space. The first article can be found here: https://seercap.com/wp-content/uploads/2024/07/Reg-Cap-A-Better-Way-for-Private-Credit-to-Partner-With-Banks.pdf

Global Reg Cap Market

The global Reg Cap market has experienced substantial growth and evolution in recent years, driven by regulatory changes and banks' need for capital optimization. Reg Cap transactions allow banks to transfer credit risk from their core loan portfolios to investors, freeing up regulatory capital and improving their capital ratios.

Figure 1: Reg Cap Market Growth



Source: IACPM

The Reg Cap Market is growing significantly, with €34 billion of risk placed in the past 2 years, vs a total of €48 billion over the prior 6 years

In the past two years, €34 billion of risk was distributed globally, referencing €420 billion of assets. This compares to €48 billion of risk referencing €600 billion of assets in the **six** years prior to that.

Europe – The European market (including the UK) dominates the Reg Cap space, accounting for 67% of total issuance since 2016. The product benefits from an established regulatory framework in Europe and the UK, which has enabled banks to use Reg Cap trades for over two decades as a strategic tool for capital management.

European and UK 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 to support lending activity, as shown in Figure 2.

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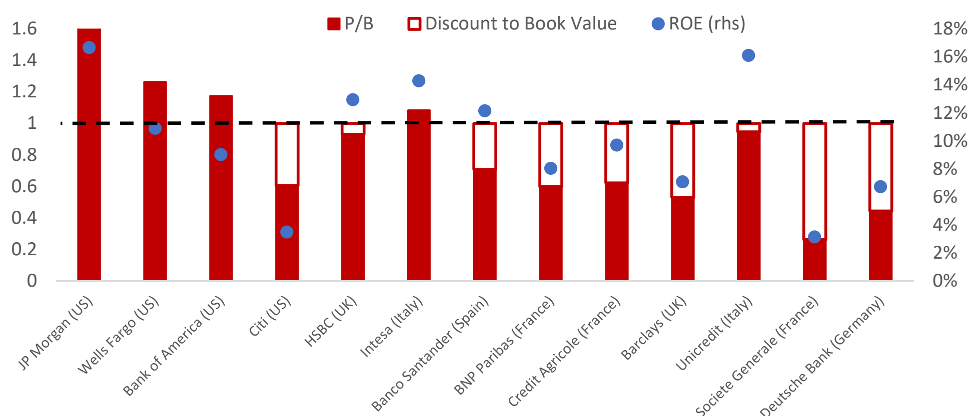
Figure 2: Price to Book and ROE of Large Banks



Source: Bloomberg, as at 6/21/2024

Canada – The Reg Cap space in Canada has been gaining significant momentum since 2022. The Canadian regulatory framework has allowed Canadian banks to utilize Reg Cap trades more readily compared to their US counterparts. 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, and small ticket CRE loans, among others. 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 below, and (iii) capital required for M&A activity. Per Bloomberg, Canadian synthetic securitizations more than doubled from C$40 billion in 2022 to C$87 billion in 2023.

USA – US banks joined the Reg Cap fray in 2023, following certain regulatory changes proposed by US federal bank regulators in 2023. **The US Reg Cap market will be the subject of our next paper.**

Reg Cap Benefits for Banks

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
Support Lending	• **Demonstrate ability to distribute risk** • Establish capital market benchmarks for the cost of lending / capital
Manage Risk	• Reduce credit loss provisioning volatility • Manage exposure to large clients • Manage exposure to specific business lines or sectors

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Increasingly Onerous Bank Regulation Drives Reg Cap Growth

Global banking standards are established by the Basel Committee on Banking Supervision, a committee of the Bank for International Settlements ("BIS")[1], and then implemented by banking regulators in each jurisdiction.

Among the critical changes under the latest Basel standards ("Basel IV", announced in 2017) are new restrictions on using bank internal models for calculating capital requirements. Regulators felt that bank internal models can underestimate the riskiness of banks' portfolios and the amount of capital they need to hold. Accordingly, banks are now forced to use a "standardized approach", which applies 100% risk weighting to most loans. Basel IV introduced an "output floor", which mandates that banks hold capital equal to at least 72.5% of the amount calculated using the standardized approach, regardless of the capital calculations resulting from bank internal models.

For more information on bank capital calculations, 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, incentivize banks to include less risky assets in Reg Cap transactions

The output floor is expected to increase overall capital required for many European banks when it comes into force starting in 2025. The US already has an output floor implemented by the Dodd Frank Act and is in the process of adjusting bank capital regulations to be more consistent with global standards overall, as we will detail in our next research report.

The output floor creates interesting opportunities for Reg Cap investors.

- It results in different relative risk weights for assets, making it more attractive for banks to issue Reg Cap transactions backed by a wider array of portfolios, including consumer assets.
- It incentivizes banks to include higher credit quality assets in reference portfolios, since higher credit quality assets would now require more capital under the standardized approach.

Increasingly onerous and complex capital regulations are inefficient, creating pockets of assets on bank balance sheets where the capital treatment is more onerous than appropriate given 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 to obtain capital relief, while investors assume limited credit risk.

While these regulatory changes are behind much of the growth in Reg Cap issuance, market growth is self-reinforcing. Issuing a first-time deal requires considerable effort and internal coordination, especially for banks below the largest tier.

[1] The BIS (Bank for International Settlements), owned by its member banks, was so named because of its role in managing WWI reparations nearly 100 years ago, and has had various roles over its history. Currently, it provides gold and foreign bank transactions for member central banks and holds central bank reserves. Its primary function today is as an industry "think tank" addressing issues of global financial stability through groups like the Basel Committee.

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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. Canada is a prime example, as noted above. 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	Resi 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 issuing bank. Seer prefers pools of assets other than large corporate loans, such as auto loans, small and medium enterprise ("SME") loans, etc., which have accounted for a significant share of the market growth in recent years. These 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 large 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.

In our next article, we will focus on the nuances of the US Reg Cap market.

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