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Reg Cap Recap

A biweekly update on the Regulatory Capital Relief/ Significant Risk Transfer sector

July 9, 2024

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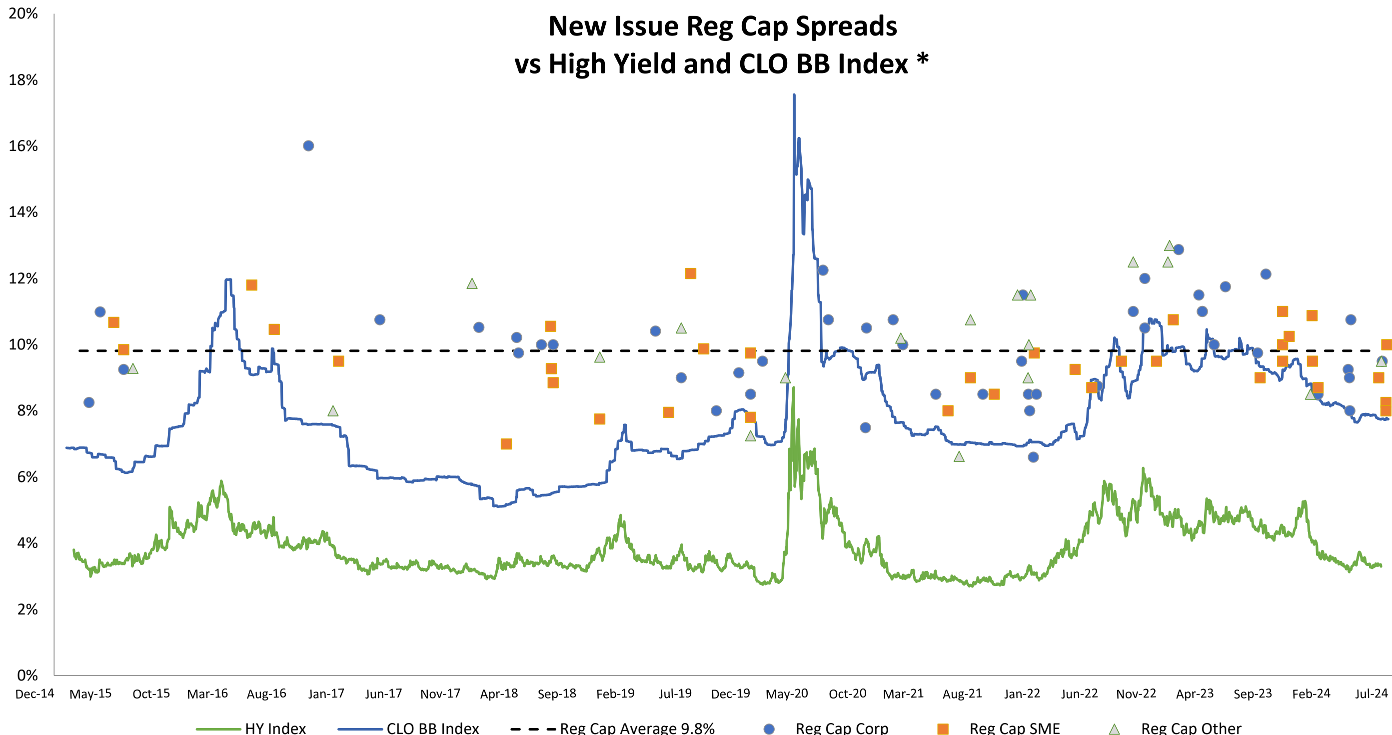
Reg Cap Spread Trends

Reg Cap spreads for new issue ranged from 800 to 1000 bps in June, marginally tighter than recent prints, while HY spreads widened by 8 basis points on the month and the BB CLO index tightened by 4 basis points.



* *Source: Seer Capital Research / Bloomberg. Reflects selected first and second loss tranches but excludes mezzanine and thick (i.e. 0-12.5%) tranches. As of July 2, 2024.*

Recent New Issue Activity

The following is a representative listing of recent new issue activity.

		ASSET			PORTFOLIO SIZE		
Pricing Date	Spread (bp) [1]	Type	Jurisdiction [2]	Disclosure [3]	Currency	Amount (bn)	First Loss [4]
Jun-24	1000	SME	UK	No	GBP	1.68	No
Jun-24	800	SME	Portugal	No	EUR	1.635	No
Jun-24	825	SME	Spain	No	EUR	1.16	No
Jun-24	950	Lev Loan	Global	No	USD	1.5	No
Jun-24	950	Corporate	UK	Yes	GBP	1.35	Yes
Jun-24	900	SME	Germany	No	EUR	2.562	No
Jun-24	825	Auto	US	No	USD	4	No
Jun-24	875	Auto	US	No	USD	2.3	No
Jun-24	825	Auto	US	No	USD	2.5	No

[1] *Spread to SOFR*
[2] *Asset jurisdiction and issuer jurisdiction may vary*
[3] *Disclosure of obligors in the reference pool of assets by name*
[4] *Indicates whether the Reg Cap issue is in the first loss position*

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Market Commentary

We believe Reg Cap/SRTs to be one of the most attractive opportunities within fixed income. Regulatory and business pressures on banks globally continue to drive issuance growth. US regulatory clarification in 2023 opened the domestic market, triggering an initial wave of issuance, along with a lot of press coverage and discussion.
Spreads remain in the high single digits, 50-100 bps tighter than 6-12 months ago, while many other fixed income products have tightened more significantly in the face of aggressive demand for risk assets. Some large investors have entered the Reg Cap market recently, openly touting it as a relative value play and focusing on pent up supply from US banks. We caution that fund managers with little prior experience in Reg Cap (despite marquee firm names) seeking to deploy large amounts of capital in complex Reg Cap transactions are likely to accept lower remuneration at best and assume inordinate risks at worst. Seer Capital portfolio managers have been involved in the Reg Cap space for over two decades.
https://seercap.com/wp-content/uploads/2024/06/Reg-Cap-Junior-Tranches-Offer-the-Best-Risk-Adjusted-Returns-in-FI-June-2024-1.pdf

Reg Cap News

Blind Bets on Bank Risk Transfers Have Never Been So Rife (Bloomberg News aka "BN," 6/ 3/24), Significant Risk Transfer transactions (aka SRT, aka Reg Cap) often reference "blind pools," i.e. pools of assets that do not include the names of the underlying borrowers/credits/obligors. Some consider blind pools to be de facto riskier than disclosed pools. We note, however, that blind pools have always been common in Reg Cap for operational, competitive, and privacy reasons. The article also mentions Reg Cap is increasingly tied to pools of consumer loans, which are blind. As a practical matter (and apart from privacy reasons), the utility of the names of individual consumers in a pool of, say, 30 thousand auto loans would be questionable in any event. The creditworthiness of large pools of consumer assets are based on underwriting criteria, loan metrics, and historical performance. As for blind pools of corporate loans, with proper criteria, history and concentration limits, risk can be managed. Moreover, Reg Cap investors should view themselves not as simple investors in a given pool but as *partners* in a bank lending program…if only because these pools are rarely static and banks are able to substitute loans. At Seer we prefer deals backed by granular portfolios, where an idiosyncratic default of a large single credit does not have a significant impact on the outcome. Most granular portfolio deals, whether referencing consumer or small and medium enterprise loans, reference blind pools.

JPMorgan's Risk Swap Ends Up at Familiar Place: Rival Banks (BN 6/12/24), When JPMorgan issued their landmark $2.5bn Reg Cap deal last year, reportedly "most" purchasers, including hedge funds and private credit funds, used outside financing to participate, be it via repos or net asset-value loans, (popular with private equity firms, these loans are secured against a portfolio of holdings and are not subject to margin calls when the value of the assets decline). Widespread use of leverage is a newer phenomenon for Reg Cap investors and is driven in part by the uptick in US issuance. US Reg Cap issuance has generally been higher-quality (both in terms of the reference assets and the thickness of the tranche) and thus lower-yielding than the (more established) European market. As a result, many investors have turned to leverage to earn the higher returns to which they'd become accustomed. With leverage, returns jump from high single digits to the mid-teens. Meanwhile, this use of leverage presents a conundrum for regulators. Reg Cap transactions are designed to transfer risk from banks to non-bank investors, thereby reducing overall risk within the banking system. However, if banks provide leverage to these same investors for purchasing Reg Cap securities from other banks, they are inadvertently reintroducing some of that risk back into the banking system. Nomura, Morgan Stanley, NatWest, Banco Santander and Standard Chartered all provide leverage on Reg Cap. The magnitude of this issue is uncertain, given the private bilateral nature of such financing, but we might see regulatory action on this topic. At Seer, we believe limited, conservatively structured leverage can enhance returns for Reg Cap investors without introducing inordinate risks to the investors or to the financial system. Leveraged structures were tested during the pandemic, with little or no forced selling of Reg Cap during the market dislocation. On the other hand, we do believe it would be helpful for the market if US issuers would split tranches into a junior, i.e. 0-6%, and senior, i.e. 6-12.5%, rather than relying on investors to arrange leverage on their own. We believe this sort of split-tranching, long a feature of the European market, will take hold in the US.

Helaba plans to issue a Reg Cap deal (BN, 6/21/24), According to Bloomberg, the German bank Helaba is planning a new Reg Cap deal referencing a €2 billion pool of corporate loans. Helaba first entered the market in 2022 with a CLN deal tied to corporate loans. Dutch and Swedish pensions funds were investors. The article notes that Reg Cap is the fast-growing part of the credit markets, which are estimated to total over €206 billion in 2023, up from around €97 billion in 2020. Other deals in the works include a UniCredit S.p.A. transaction tied to a portfolio of loans to German SME, and a Deutsche Bank deal linked to leveraged loans.

Federal Reserve Floats Weaker Version of Bank-Capital Revamp (BN, 6/24/24), It was reported that the Federal Reserve is re-considering its proposed expansion of bank capital requirements. Some estimates suggested that the largest banks would face a 16% increase in capital requirements under the original proposal (vs. only 10% for EU banks) but the new figure may be closer to a 5% increase for US banks. The push to increase capital requirements has its roots in the 2008 GFC and gained new momentum following US bank failures in March of 2023. But after intense lobbying (and disagreement within the ranks at the Fed's board), it appears the Fed is softening its approach. The timeline to finalize the plan is supposed to be August. If delayed until after the election, a power shift might also change the outcome.

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Reg Cap News (continued)

In either case, US bank Reg Cap issuance may not be quite as heavy as some forecasted. No doubt issuers will still find it to be a highly useful tool for regulatory as well as business reasons. The EU is taking a wait-and-see approach on a revision to how trading book assets are treated, to ensure that they don't enact rules that place EU banks at a competitive disadvantage with US banks.

Big Banks Sail Through Stress Test in Harbinger for Payouts (BN, 6/26/24) The results of the Federal Reserve's annual stress test were robust. The Fed looks at 31 US banks (all with over $100bn in assets) and does scenario testing to evaluate capital adequacy in the event of a recession (e.g. 10% US unemployment, a 55% drop in equity market and a 40% decline in commercial real estate). All 31 banks had adequate capital under this scenario, and in aggregate the equity Tier 1 capital ratio would bottom out at 9.9% under thus severe stress, leaving banks with more than double the 4.5% minimum requirement for that metric. Results ranged from a stressed capital level of 12.5% (down from 15% unstressed) at JPMorgan Chase to 8.1% (down from 11.4% unstressed) at Wells Fargo. Regulators cited higher credit card delinquencies, riskier corporate credit, and a combination of higher costs in continuing to call for an increase in capital buffers. It was later reported that based on the stress test results, the Stress Capital Buffer, one of the components of the minimum CET1 capital requirement, stands to increase for most of the largest US banks, including JP Morgan, Bank of America, Morgan Stanley, Goldman Sachs, and Wells Fargo. This could stimulate further Reg Cap issuance by US banks.

Endgame for US Banks Might Be a Big Fat Nothing (BN, 6/26/24) In this opinion piece, the author notes that an industry lobbying campaign has been very successful in getting bank regulators to walk back their initial plans to dramatically raise capital requirements in the wake of the SVB collapse over a year ago. A group of eight banks underwrote a TV advertising campaign, arguing that these new regulations would hamper credit access for ordinary Americans. The author calls these claims "overblown" but avers they were highly effective in getting legislators to pressure banking regulators to reconsider. Chairman Powell is now promising "broad and material changes" to the new capital rules. The author acknowledges the complexity of the rules and issues of parity for banks around the globe, while also insisting that changes to the rules are needed. "Despite the battering they've taken from politicians and the mistakes they've made in writing the rules, they still need the fortitude to ensure that they capture the right risks and in a way that is internationally consistent."

One of the Hottest Trades on Wall Street, an Etymological Study (BN, 6/27/24) What we refer to as "Reg Cap" has, somewhat confusingly, gone by a series of different names over its history. Initially this sector was referred to as synthetic balance sheet CLOs, then Reg Cap, and more recently SRT or "significant risk transfers." The name has evolved for several reasons, including wanting to avoid confusion (or taint) of unrelated products post GFC. Regardless of the terminology used, they all have two common aspects. Firstly, they are "synthetic" in that a pool of reference assets is used, and no loans are sold outright. The issuing bank is effectively purchasing insurance on the credit performance of those reference assets. The second common aspect, and we think the most important, is that the transaction is done for the purposes of regulatory relief, not for funding and generally not for arbitrage. Because we consider the purpose of Reg Cap and the issuer's motivations to be defining characteristics, we prefer the term "Reg Cap Relief ," or simply "Reg Cap."

About Seer

Seer Capital Management LP is a diversified, credit-focused investment firm founded by Phil Weingord in 2008 that primarily invests in structured credit and loans. We allocate capital opportunistically across all major asset classes within structured credit in the U.S. and Europe, including: bank regulatory capital risk transfer (SRT), residential and commercial mortgages, syndicated and SME loans, and a variety of consumer loans (personal, auto, credit card, student, housing). These investments are executed through active trading in both legacy and new issue securitizations, purchase and securitization of whole loans, and direct lending joint ventures.

Seer Capital believes it is well positioned to capitalize on opportunities in structured credit as a result of our highly experienced senior investment team, which has on average more than two decades of experience working in structured credit.

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